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Edited by
Miranda Stewart

Postal Address:
Atax, Faculty of Law,
UNSW, NSW 2052
Australia
Phone: +61 2 9385 9562
E-mail:
m.mckerchar@unsw.edu.au

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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

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TABLE OF CONTENTS

Volume 2, Number 1
December 2006

FOREWORD iv

Addresses

THE CONTRIBUTION OF JUSTICE HILL TO THE DEVELOPMENT OF TAX LAW IN AUSTRALIA *Justice Richard Edmonds* 1

IT IS THE COMMUNITY'S TAX SYSTEM *Commissioner Michael D'Ascenzo* 9

Articles

WHAT'S SEX GOT TO DO WITH IT? TAX AND THE 'FAMILY' IN CANADA
Claire F L Young 16

AN OLD TAX IS A SIMPLE TAX: A BACK TO THE FUTURE SUGGESTION FOR THE SIMPLIFICATION OF AUSTRALIAN CORPORATE-SHAREHOLDER TAXATION
C John Taylor 30

WHY TAXING THE MICRO-BUSINESS IS NOT SIMPLE — A CAUTIONARY TALE FROM THE 'OLD WORLD' *Judith Freedman* 58

SMALL BUSINESS TAX ADVANTAGES — TOWARDS HOLISM WITH A SUGGESTED DEFINITION, TYPOLOGY AND CRITICAL REVIEW *Mark Burton* 78

THE TAX OFFSET FOR ENTREPRENEURS: A CRITICAL REVIEW OF THE 25 PER CENT TAX OFFSET FOR SMALL BUSINESS *John McLaren* 107

THE COSTS AND BENEFITS OF COMPLYING WITH THE TAX SYSTEM AND THEIR IMPACT ON THE FINANCIAL MANAGEMENT OF THE SMALL FIRM
Phil Lignier 121

AN OLD METHODOLOGY IN A NEW WORLD: A COMMENT ON OUR CURRENT SYSTEM OF JUDICIAL DECISION MAKING IN TAX CASES *Justin Dabner* 144

NEW TAX LAWS TO DETER PROMOTERS OF TAX EXPLOITATION SCHEMES
Rachel Tooma 158

RESEARCHING TAX USING TECHNOLOGY: A SURVEY OF STUDENT ATTITUDES
Jennifer Butler 178

FOREWORD

The addresses and articles in this, the second volume of the *Journal of the Australasian Tax Teachers Association* ('JATTA') are largely drawn from papers presented at the 18th Annual Conference of the Australasian Tax Teachers Association ('ATTA') held from Monday 30 January to Wednesday 1 February 2006 at University of Melbourne Law School, Melbourne, Australia.

The 18th Annual Conference paid tribute to the immense contribution made by the late Graham Hill, who was patron of ATTA, to taxation law, scholarship and teaching in Australia. The Conference opened with an address by Justice Richard Edmonds of the Federal Court in honour of Justice Hill. This was followed by the inaugural address of Michael D'Ascenzo in his new role as eleventh Commissioner of Taxation in Australia. ATTA congratulates Commissioner D'Ascenzo on his appointment to this position, which is one of extraordinary importance to the Australian community. Commissioner D'Ascenzo, who is a long-time supporter of ATTA, discussed the role of tax teachers in both teaching the tax law and influencing their students in creating a responsible community because 'it is the community's tax system'. Both addresses are in this volume.

The theme of the conference was 'Old Taxes in a New World'. There were nearly 60 papers presented. The peer reviewed articles in this volume present a small slice of those papers and it is believed that they will make a significant contribution to the literature. Included are the papers presented by international keynote speakers Professor Claire Young of the University of British Columbia, Canada on tax treatment of opposite-sex and same-sex spouses and Professor Judith Freedman of Oxford University in the United Kingdom on the difficulties of designing tax laws for small business. The taxation of small business turned out to be a topic of significance at the conference and this volume contains several articles on that topic. This volume also includes the outstanding paper by Associate Professor John Taylor of the University of New South Wales on reform of the corporate tax, which was awarded the prize for *Best Senior Paper* at the conference, and papers on promoter penalties, the costs of our system of case decision in tax cases and student attitudes to researching tax with technology.

It was an honour to host the 18th Annual Conference of ATTA at Melbourne Law School. Many contributed to the success of the conference. Thanks to all involved.

Miranda Stewart (University of Melbourne, Australia)

11 December 2006

THE CONTRIBUTION OF JUSTICE HILL TO THE DEVELOPMENT OF TAX LAW IN AUSTRALIA

JUSTICE RICHARD EDMONDS*

I INTRODUCTION

At the time of his death in August 2005, the late Justice Graham Hill was undisputedly, and deservedly, recognised as the leading tax judge in this country. As I said on a previous occasion, we, and I include in that the members for the time being and from time to time of the High Court of Australia, may not have always agreed with his Honour's views nor his conclusions in tax matters, but in the vast majority of cases we did.

I have been invited today to address this Conference in its opening plenary session, on the late Justice Hill's contribution to the development of tax law in this country. I readily accepted the invitation because of my respect and admiration for a great jurist in a field of endeavour in which I have always aspired to succeed. I have come to accept that I will never succeed to the extent that his Honour did, however, that acceptance is no bar or impediment to one's own aspirations. I knew his Honour, personally and professionally, for over 30 years: first as a student; then as a fellow practitioner, as a solicitor and then as a fellow member of the Bar; then as a judge of the Federal Court of Australia before whom I appeared on many occasions, successfully and unsuccessfully; and finally, for too short a period, as a colleague on the Court.

His Honour's contribution to the development of tax law in this country manifested itself through a number of mediums, and I propose to say something about each of them.

II ROLE AS A SCHOLAR

In his early days as a scholar, Graham Hill's personal achievements, as distinct from his contribution to the development of tax law in Australia, was nothing short of brilliant.

Educated at Fort Street Boys High School, after gaining a maximum pass in the NSW Leaving Certificate he went up to the University of Sydney where he gained a Bachelor of Arts and Bachelor of Laws, the latter with First Class Honours, winning the University Medal in law. That was in a year in which the graduating class included Chief Justice Gleeson of the High Court of Australia, Justice Kirby of the High Court of Australia and Justice Hodgson, a judge of the New South Wales Court of Appeal.

In 1962 his Honour moved to Harvard University on a Ford International fellowship, a Fullbright scholarship and a Sydney University postgraduate scholarship. He graduated as a Master of Laws in 1963. While there, he studied under the Dean of the Faculty of Law, Professor Erwin Griswold, who was widely regarded as the leading tax law scholar in the United States and later became the US Solicitor-General. His Honour then went to Britain where he spent a year as a postgraduate scholar at the London School of Economics and came under the influence and tutelage of the late Professor Ash Wheatcroft.

But it was on his return from overseas that his Honour's contribution to the development of tax law in Australia as a scholar first manifested itself. Through the persuasion of the late Justice Russell Fox, a founding judge of the Federal Court of Australia, with whom his Honour had been associated at the University of Sydney for several years in teaching the subjects of stamp, death,

* Justice of the Federal Court of Australia.

estate and gift duties, Justice Hill wrote and published, through the Law Book Company, his seminal work: *Stamp, Death, Estate and Gift Duties (New South Wales, Commonwealth and Australian Capital Territory)*.¹ In the preface to this work, his Honour wrote:

The starting point of this book was *The Law Relating to Stamp, Death, Estate and Gift Duties* by R C Smith. The third edition of that book was published in 1953 and by supplement brought up to date to 1 February 1957. It has for many years now been out of print. The present book differs, however, in many ways from that written by Mr. Smith ...

This book owes a debt of gratitude to many people. Mr Neil McIntyre, my former senior partner, first set me on the road of exploring stamp duty; Professor Wheatcroft of the London School of Economics and Political Science directed my thinking and research more deeply into the topic; but it was Mr Justice Fox, then lecturer in Stamp, Death, Estate and Gift Duties at the Law School of the University of Sydney, who instilled in me the courage to attempt this book. I am grateful to him for the insight he gave me, for his constant reminders to return to the words of the legislation and for the wealth of knowledge he imparted to me born of his close practical association with the subject ...

Many others have given me encouragement and assistance ... My thanks are also due to Mr Gordon Taylor of the AMP Society for his assistance in discussions on the provisions of the Stamp Duties Act dealing with insurance, to Professor Parsons and Mr Peden of the Law School of the University of Sydney for suggesting avenues of research from time to time and for their comments.²

In his foreword to his Honour's work, the late Justice Fox said this:

My part in the preparation of this book has been without effort and without anguish; I persuaded Mr. Hill to write it, and left him to do the work. We were associated together at the University of Sydney for several years in teaching the subjects with which it deals, and we both became most conscious of the need for a good up-to-date book in the field.

I can only say that I am most gratified at the result of his considerable labours. It is certainly the most comprehensive and thorough work yet to appear on the law of stamp, death, estate and gift duties. There is information to answer the routine enquiry, and informed and intelligent commentary to aid the solution of the serious problem. The field is a difficult one, in which precise analysis of the legal nature of a transaction is but the starting point for the consideration of legislation which too often betrays neither clarity of concept nor symmetry of scheme. Uncertainties result for all concerned — uncertainty as to what to do, or what to assess, or what to pay. The present work, it may confidently be expected, will help to reduce the area of uncertainty, by giving a wide range of people a closer and readier insight into the operation and application of the legislation.³

For those of us who lived and practised through this period when his Honour's work first appeared, it is fair to say that the expectations of Justice Fox were not only fulfilled, but exceeded. His Honour's work came to be the benchmark in the field of endeavour which it covered and, not surprisingly, formed the basis of his Honour's great contribution to the development of this area of tax law in Australia. It was supplemented by the many papers he wrote and presentations he made on 'cutting edge areas' in these fields. That very much continued until Queensland abolished death and gift duties in 1976, New South Wales and Victoria abolished death duties in the same year and the Commonwealth and other states had followed suit by 1979.

His Honour's work made such an outstanding contribution to the development and understanding of the law in this country in the fields of stamp, death, estate and gift duty, that even today, the work, in a modified version devoted to stamp duty, still exists as a leading text in the field. That that is so nearly forty years after it was first published, speaks for itself. A great many students, equally as many practitioners and perhaps fewer judges, albeit only because there are fewer of them, have benefited from his Honour's commentary and observations in this work. I do not think I can give it higher praise than by saying that his Honour's work on stamp, death,

¹ D Graham Hill, *Stamp, Death, Estate and Gift Duties (New South Wales, Commonwealth and Australian Capital Territory)* (1970).

² *Ibid*, vii – xi.

³ *Ibid*, v.

estate and gift duties and its successor on stamp duties is, in scholastic expertise, the composite equal of *Sergeant and Sims on Stamp Duties and Capital Duty*⁴ and *Dymond's Death Duties*.⁵

III ROLE AS A TEACHER AND LECTURER

Next, I come to his Honour's contribution to the development of tax law in Australia in his role as a teacher and lecturer. This was a contribution which started at a fairly early time in his Honour's professional career, but continued until the day before his Honour died. For those of you who do not know, his Honour gave his last lecture in the indirect tax course in the Master of Laws programme at the University of Sydney, on the evening before he died.

From the time of his return to Australia in the mid 1960s, his Honour joined Justice Fox in lecturing to students in the postgraduate Master of Laws course offered by the University of Sydney Law School. His Honour lectured in stamp, death, estate and gift duties, subsequently in sales tax and more recently in Goods and Services Tax ('GST') principles. In 1967 his Honour became Challis Lecturer in Taxation Law, a part-time post he held for 39 years until he died. At the time of his death he was Sydney Law School's longest serving teacher, lecturing every term for the past forty years, and had, according to the Chancellor of the University of Sydney, his Honour Justice G F K Santow OAM, a research and publication record of which a full-time academic could be proud. I was one of his students in the early 1970s, along with two of my colleagues from Allen Allen and Hemsley at the time, the late Justice John Lehane of the Federal Court of Australia and Justice Reg Barrett of the New South Wales Supreme Court. As well, there were many leading members of the Bar, of the solicitor's profession and of the different bodies of accountants wishing to pursue further studies in the field of revenue law. His Honour's contribution to the further education of all these people has been enormous.

But it was not only at the University of Sydney that his Honour's role as an educator contributed so greatly to the development of tax law in this country. It was also through organisations such as the Taxation Institution of Australia, the Law Council of Australia, the Law Society of New South Wales, the New South Wales Bar Association, the Australian Tax Research Foundation, the International Fiscal Association, to mention some, not to mention this Association, the Australasian Tax Teachers' Association. In addition, there were many other private organisations and groups to which his Honour belonged, of which I mention one, the Gunn Club (having nothing to do with firearms) — named after its founder, Mr J A L Gunn, the well-known and highly respected tax accountant and author of the middle decades of the last century. His Honour's work for these organisations and bodies in giving lectures, writing and presenting papers, conducting workshops, leading discussion groups and generally just participating in revenue law subjects was prolific.

His Honour's contribution to the development of tax law in Australia in his role as a teacher and lecturer is best exemplified in recent times in the way his Honour, in consequence of the introduction of the GST, developed and structured a program devoted to the study of GST principles as part of his indirect tax course in the Master of Laws program offered at the University of Sydney Law School. It was a program, which, as far as I am aware, had no parallel in New South Wales and few, if any, parallels in other States. Not surprisingly, his indirect tax course was heavily patronised and this was no doubt one of the reasons why.

⁴ B J Sims, *Sergeant and Sims on Stamp Duties and Capital Duty* (8th ed, 1982).

⁵ Reginald K Johns, *Dymond's Death Duties* (14th ed, 1965).

IV ROLE AS A PRACTITIONER

When his Honour returned to Sydney in the mid 1960s he joined Parish Patience & McIntyre and became a partner in that firm. In 1970, he left that firm and became a partner at the firm which was then known as Dawson Waldron Edwards & Nicholls. He remained there until 1976 when, at the age of 37, he was admitted to the New South Wales Bar. During the next thirteen years he established himself as one of the country's premier tax advocates. In 1984, after nearly nine years at the Bar, he was appointed a Queen's Counsel.

In 1980–81 he and A M Gleeson QC, as his Honour then was, were invited by the present Prime Minister, then the Federal Treasurer, to assist in the drafting of a general anti-avoidance provision to take the place of s 260 of the *Income Tax Assessment Act 1936* (Cth) ('ITAA36') which, rightly or wrongly, probably the latter, was perceived by many as having been effectively emasculated by the High Court of Australia.

I'll say something more about his Honour's contribution to the development of tax law in Australia in the context of Part IVA of the *ITAA36* when I speak of his role as judge of the Federal Court, suffice it is to say now that his involvement with our current general anti-avoidance rule from before its birth in 1981 up to and including his participation in the Full Court in *Commissioner of Taxation v Hart* (2004) 217 CLR 216 and as the trial judge in *Macquarie Finance Ltd v Commissioner of Taxation* (2004) 210 ALR 508 has led to his Honour having made an indelible contribution to the development of the law in this area. Some might well say that it is his most important contribution and time might well prove them right.

His Honour's contribution to the development of tax law in his role as a practitioner is best exemplified through a review of a number of the cases in which his Honour appeared, both for the taxpayer and the Commissioner. Time does not permit me to undertake such a review on anything approaching a basis which would do justice to his Honour, however, the names will be readily familiar by mentioning only a few of the more than 150 tax cases in which his Honour appeared:

- Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314
- Federal Commissioner of Taxation v St Hubert's Island Pty Ltd* (1978) 138 CLR 210
- Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* (1979) 43 FLR 217
- Federal Commissioner of Taxation v Tourapark Pty Ltd* (1980) 49 FLR 17
- Federal Commissioner of Taxation v Everett* (1980) 143 CLR 440
- Federal Commissioner of Taxation v St Helens Farm (ACT) Pty Ltd* (1981) 146 CLR 336
- Federal Commissioner of Taxation v Totledge Pty. Limited* (1982) 40 ALR 385
- AVCO Financial Services Limited v Federal Commissioner of Taxation* (1982) 150 CLR 510
- DKLR Holding Co (No 2) Pty Ltd v Commissioner of Stamp Duties (NSW)* (1982) 149 CLR 431
- Brayson Motors Pty Ltd v Federal Commissioner of Taxation* (1983) 57 ALJR 288
- Mutual Acceptance Ltd v Federal Commissioner of Taxation* (1984) 81 FLR 209
- Federal Commissioner of Taxation v Walker* 84 ATC 4553
- Federal Commissioner of Taxation v Australian Guarantee Corporation Ltd* (1984) 2 FCR 483
- Brayson Motors Pty Ltd v Federal Commissioner of Taxation* (1985) 156 CLR 651
- Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* 85 ATC 4432
- Federal Commissioner of Taxation v Galland* (1986) 162 CLR 408
- Commissioner of Stamp Duties (NSW) v J V (Crows Nest) Pty Ltd* (1986) 7 NSWLR 529

Smith v Federal Commissioner of Taxation (1987) 164 CLR 513
MacFarlane v Federal Commissioner of Taxation (1986) 13 FCR 356
Federal Commissioner of Taxation v Creer (1986) 65 ALR 485
Federal Commissioner of Taxation v Gregrhon Investments Pty Ltd (1987) 76 ALR 586
North Coast Grazing Pty Ltd v Federal Commissioner of Taxation (1987) 15 FCR 104
Australian National Hotels Ltd v Federal Commissioner of Taxation (1988) 81 ALR 667
Federal Commissioner of Taxation v Citibank Limited (1989) 20 FCR 403

V ROLE AS A JUDGE OF THE FEDERAL COURT OF AUSTRALIA

But it was in his role as a judge of the Federal Court of Australia that his Honour made his greatest contribution to the development of tax law in this country. Indeed, his Honour sat on the bench of the Federal Court of Australia for over 16 years, for a large part of which he was acknowledged and recognised as the leading tax judge in Australia.

Not long after his death, his former personal assistant devoted a considerable amount of time to preparing a list of all his Honour's judgments in tax matters that had come into his docket as well as a list of all Full Court judgments in which his Honour participated as a member of the Court. There are a number of indicia of this list which immediately strike you. First, its sheer size: his Honour delivered one hundred and seven Full Court judgments and one hundred and nine judgments at first instance. Secondly, the cases give rise to a tremendous diversity of issues. Thirdly, only relatively few cases finished up in the High Court — approximately ten:

Commonwealth v Genex Corporation Pty Ltd (1992) 176 CLR 277
Federal Commissioner of Taxation v Peabody (1994) 181 CLR 359
Federal Commissioner of Taxation v Australia & New Zealand Savings Bank Ltd (1994) 181 CLR 466
Federal Commissioner of Taxation v Prestige Motors Pty Ltd (1994) 181 CLR 1
Federal Commissioner of Taxation v Energy Resources of Australia Ltd (1996) 185 CLR 66
Federal Commissioner of Taxation v Consolidated Press Holdings Ltd (2001) 207 CLR 235
Federal Commissioner of Taxation v Hart (2004) 217 CLR 216
Federal Commissioner of Taxation v Linter Textiles Australia Ltd (2005) 79 ALJR 913
Federal Commissioner of Taxation v Stone (2005) 79 ALJR 956

His Honour had an enormous capacity to turn judgments around and he did so, generally speaking, without sacrificing quality in the reasoning process. The best example of this is his Honour's judgments at first instance in what were colloquially known as the 'Packer tax cases'⁶, cases involving companies within the private ownership of the late Mr Kerry Packer and his family. They all involved the most complex of issues in the interpretation of the *ITAA36* — the application of s 177E for the first time; the application of s 177D to a scheme the parties to which, it was alleged, had the dominant purpose of evading the quarantining provisions of s 79D; the application of Part X dealing with controlled foreign companies to a defeasance profit of a kind which arose in *Unilever Australia Securities*⁷ and *Orica*;⁸ and the interaction of the provisions of Part X and the thin capitalisation provisions of Division 16F to controlled foreign companies.

⁶ *Consolidated Press Holdings Ltd v Federal Commissioner of Taxation* (1998) 88 FCR 21 and 151.

⁷ *Federal Commissioner of Taxation v Unilever Australia Securities Ltd* (1995) 56 FCR 152.

⁸ *Federal Commissioner of Taxation v Orica Ltd* (1998) 194 CLR 500.

The cases were heard at first instance by his Honour over a period of six days and his Honour turned the judgments around in all four cases in little over fourteen days.⁹ Not everyone agreed with his Honour's findings of fact or conclusions of law,¹⁰ but I do not believe any other judge in this country could have replicated that performance with the quality of the reasoning process.

It is possible to discern perhaps three areas where, through the cases he decided, his Honour made a significant contribution to the development of tax law in this country.

First, in the ever evolving concept of 'income', particularly following the decision of the High Court of Australia in *Federal Commissioner of Taxation v Myer Emporium Limited* (1987) 163 CLR 199. *Myer* was decided not long before his Honour's appointment to the Bench and it was not long after his appointment that his Honour was called upon to first consider its application in *Cooling*¹¹ and *Westfield*.¹² His Honour's contribution in this area, in particular in relation to what has become known as the 'second stream' of *Myer*, is exemplified in his reasons for judgment in cases such as *Henry Jones (IXL)*¹³ and *SP Investments*.¹⁴

The second area where his Honour's contribution can be clearly seen is in the area of statutory construction. This is best exemplified, in one of the last judgments in which his Honour participated on the Full Court, namely *HP Mercantile*.¹⁵ Stone and Allsop JJ agreed with his Honour's reasons, however, importantly Allsop J said:

Were it not for the matters with which his Honour deals concerning the statutory scheme and the purpose and the context of the legislation, I would be inclined to the view that the acquisition of legal and management services in collecting the debts did not relate to making the relevant supply, being the acquisition of the book of debts. As a matter of textual meaning, it can be said that the acquisitions relate to the debts but not to the acquiring of the debts.¹⁶

In a paper which I delivered for the Taxation Institute of Australia at a GST Intensive Seminar in October of last year,¹⁷ I proffered the following conclusions concerning his Honour's approach to the matter of statutory construction in *HP Mercantile*:

As I said at the outset, it is not often that the courts are given the opportunity of interpreting legislation providing for the implementation of an entirely new tax. It provides the court with the opportunity to approach the task of statutory construction free of 'muffled echoes of old arguments' concerning other legislation.

I will be surprised if the Court's approach in *HP Mercantile* does not provide a template for the approach that will be adopted by the courts in the future, at least in cases involving the construction of provisions of the *GST Act* where there are, prima facie, competing arguments based on syntactical enquiry into the meaning of words, either standing alone or in juxtaposition with other words.

But it has to be remembered that such an approach by the Courts is not a panacea for all problems thrown up by the drafting of legislation. The purposive construction of legislation can only deal with the problem of how legislation is to be construed; it cannot deal with the problem of how it is written. There is a need for the Parliament, the Executive and the administrators who advise them to remain vigilant in identifying the wording of legislation which gives rise to unintended consequences judged against or by reference to legislative policy. The words of Kirby J, in dissent, in

⁹ The cases were heard from 21-28 September 1998; his Honour handed down his judgment on 13 October 1998.

¹⁰ His Honour's decision was reversed by the Full Federal Court in *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (1999) FCR 524 and by the High Court, which affirmed the decision of the Full Federal Court in *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235.

¹¹ *Federal Commissioner of Taxation v Cooling* (1990) 22 FCR 42.

¹² *Westfield Ltd v Federal Commissioner of Taxation* (1991) 28 FCR 333.

¹³ *Henry Jones (IXL) Ltd v Federal Commissioner of Taxation* (1991) 31 FCR 64.

¹⁴ *SP Investments Pty Ltd v Federal Commissioner of Taxation* (1993) 41 FCR 282.

¹⁵ *HP Mercantile Pty Ltd v Federal Commissioner of Taxation* (2005) 219 ALR 591.

¹⁶ *Ibid*, 609.

¹⁷ Richard Edmonds, 'Five Years of GST' (Paper presented at the Taxation Institute of Australia National GST Intensive 2005, Gold Coast, 13 October 2005), 18-19.

[*Network Ten Pty Ltd v TCN Channel 9 Pty Ltd* (2004) 205 ALR 1 at 24] to which I referred, cannot be put to one side and ignored.

As Hill J so ably put it in a paper [‘To interpret or translate? The judicial role for GST cases’, (2005) 5(11) *Australian GST Journal* 225-238]:

‘There will obviously be unintended consequences which arise in the implementation of a new tax drafted in a way which in many respects differs from comparable legislation in other jurisdictions. While, in part, such unintended consequences can be dealt with by the ruling system that is not a satisfactory long-term solution to problems. There is a need for the legislature to cure defects from time to time. Yet there seems to be a refusal on the part of the government to admit there are defects and to make amendments other than amendments which may be thought necessary to overcome avoidance. In some cases, the courts may be able to resolve difficulties by applying a purposive construction but in the Australian constitutional context where there is a sharp separation of the legislative and judicial powers there is a limit to what one can expect of the courts. Ultimately the courts can not act as legislators. Parliament can not stand by and then blame the courts if a decision is one that does not favour the revenue when the problem lies not in how the legislation is to be interpreted in a common sense way, but in how it is written.’

Finally, I want to say something about his Honour’s contribution to the development of the construction and application of Part IVA of the *ITAA36*. Having been involved in the drafting of Part IVA and in discussions with others engaged in the same task, his Honour held fairly strong views about the construction and application of Part IVA, in particular, whether it should apply to a given set of facts. These views manifested themselves for the first time when *Peabody*¹⁸ was in a Full Court where his Honour said:

The question which was required by s 177D to be answered on the facts of the present case was whether, having regard to the matters in s 177D(b), it would be concluded that Mr Peabody carried out the whole of the scheme, from acquiring the Kleinschmidt shares through the financing arrangements and concluding with transferring the shares either to the public company or to TEP Holdings Ltd, for the purpose of excluding from the assessable income of each of the three beneficiaries of the Peabody Family Trust the sum of \$888,005. One has only to pose that question to see how absurd such a conclusion would be. Clearly enough, the whole scheme, as formulated, was entered into or carried out by Mr Peabody with a dominant commercial purpose, namely, the acquisition of shares from Mr Kleinschmidt and the flotation of a public company. The fact that an element of that scheme had a tax advantage does not detract from the dominant purpose of Mr Peabody in relation to the scheme as a whole. The matters to which regard may be had under s 177D clearly direct attention on the one hand to the commercial elements of the scheme and on the other hand to the tax elements. They require a balancing of the two. But the factors which predominate in the present scheme considered as a whole are purely commercial. Once the scheme is analysed as encompassing the acquisition of shares, the financing of those shares and the ultimate flotation of a public company, it is hard to see, in a case such as the present, how the relevant conclusion as to purpose could have been drawn. Part IVA would seldom, if ever, operate to permit the Commissioner to make a determination, carrying with it as it does an automatic penalty upon a taxpayer assessed, where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor, s 260.¹⁹

Significantly, that passage did not attract any comment, adverse or otherwise, when *Peabody* went up to the High Court.²⁰ What his Honour there said helps explain the position his Honour took, with the concurrence of Hely and Conti JJ, in *Hart*.²¹ His Honour thought, rightly or wrongly, that he had an advantage of bringing to bear on the issue of the application of Part IVA, what Part IVA was intended to apply to and what it was not. His Honour may ultimately be proved to be right, however, having regard to the High Court’s decision in *Hart*²² and the very different processes of reasoning by which the various members of the Court got to the conclusion they did, it is fair to say that his Honour’s views, as expressed in the final sentences of the extract from *Peabody* cited above, do not, at this point in time, represent the law. Speaking for myself, I

¹⁸ *Peabody v Federal Commissioner of Taxation* (1993) 40 FCR 531.

¹⁹ *Ibid*, 548-9.

²⁰ *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359.

²¹ *Hart v Federal Commissioner of Taxation* (2002) 121 FCR 206.

²² *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

think that is somewhat unfortunate because his Honour's views do not carry the baggage of uncertainty which is perceived to flow from the diverse reasons of their Honours in the High Court.

On a previous occasion I said that it is unlikely we will see the likes of his Honour in the area of taxation law again; but if we do, it will not be for a long time. He was, as Professor Richard Vann aptly described him, 'a tax titan'.²³

²³ Fiona Buffini, 'Tax titan was no heir but had all the graces', *The Australian Financial Review* (Sydney), Friday 26 August 2005, 29.

IT IS THE COMMUNITY'S TAX SYSTEM

COMMISSIONER MICHAEL D'ASCENZO*

I INTRODUCTION

Thank you for the opportunity to share with you the exciting challenges I see in my new role as Australia's eleventh Commissioner of Taxation.

I am delighted to deliver my first formal address in my new role to the Australasian Tax Teachers Association ('ATTA'). This organisation has provided me with a valuable forum for sharing perspectives and fostering a common interest in taxation over the past several years. I place tax teachers high on the hierarchy of strategic influencers in our society, and of the society we want to be. As taxation is the 'price we pay for a civilised society'¹ it is important that our citizens have the wherewithal to understand the choices available to them about taxation. These choices find voice in a policy context at the ballot box, and in a personal context in the propensity of taxpayers to voluntarily comply with their tax obligations. In short, if we as a society are to publicly fund roads, schools, hospitals and defence, and if we are to have a social safety net, then the community makes a contribution to that, in accordance with the law, through taxation. The shape and rate of taxation also impacts on social equity and the competitiveness of our economy. These are of course matters for Government and voters. The role of the Australian Taxation Office ('ATO') is to administer the tax laws fairly and efficiently.

The ATO can only play a minor role in shaping social norms about taxation. A greater responsibility rests on other community institutions including Parliament and politicians, academia, the judiciary, the tax profession, and the media. However, just as taxation is important in economic and social terms, the way the tax system is administered also reflects the nature of our society. For example, it could reflect public fiat over the rule of law or disengagement by the general public from the law and its administration. Fortunately, that is not the case in Australia.

In order to safeguard the community from administrative abuse and to nurture and foster a community that is law abiding it is important that taxpayers or their advisers have a clear understanding of their rights and obligations.

Tax teachers also have the onerous responsibility of influencing their students on these weighty matters. The importance of tax teachers to our society was driven home to me by the lifelong commitment of the late Justice Hill to the teaching of taxation. Not only was Justice Hill an inspiration to tax teachers in Australia, he also worked with other jurisdictions to promote the rule of law — all this in addition to the enormous contribution that Justice Hill made to our jurisprudence. I like many was deeply saddened by his passing. As Justice Edmonds observed today, 'I doubt that we will see the likes of Graham Hill in the revenue law area again, however, if I am wrong, then it will be a long time before we do.'²

The theme of this conference is 'Old Taxes in a New World'. There is some constancy in taxation — two things are certain, so the adage goes, death and taxes. There are also some enduring fundamentals to good tax administration. For example, throughout the 96 year

* BEc, LLB (ANU); Commissioner of Taxation, Australian Taxation Office. This is a revised version of the Commissioner's speech prepared for the 18th Annual Australasian Tax Teachers Association Conference, held at the University of Melbourne, and delivered on 30 January 2006.

¹ Justice Oliver Wendell Holmes, *Compania General de Tabacos de Filipinas v Collector of Internal Revenue* (1927) 275 US 87, 100.

² Justice Richard Edmonds, 'A Tribute to the Late Justice Graham Hill' (Speech delivered at the Law Council Workshop, Sydney, 22 October 2005); Justice Richard Edmonds, 'The Contribution of Justice Hill to the Development of the Tax Law in Australia' (Speech delivered at the Australasian Tax Teachers Association Conference, Melbourne, 30 January 2006).

history of the ATO, we have emphasised our dedication to assisting taxpayers. Indeed, Australia's second Tax Commissioner, Robert Ewing, is best remembered for his credo that '[t]he principle rule of the Department is to assist taxpayers in every possible way.'³

While we have come a long way from our beginnings with just a dozen employees based in the Department of the Treasury in Melbourne in 1910, the goal of assisting taxpayers in every possible way remains a source of inspiration for us.

II VISION FOR A WORLD CLASS TAX ADMINISTRATION

I am often asked how I am going to put my stamp on my new role, following in the footsteps of such a successful Commissioner as Michael Carmody. When I first thought about this, I reflected on my time working with Michael and of the things we, and the organisation, had achieved together. I worked with Michael for many years to make our tax administration one of the best in the world. Those are big shoes to fill.

The fundamentals of the ATO built on fairness in accordance with the law, integrity, accountability and administrative transparency, are sound. While I will have my own style and emphasis, these values remain the same. My starting point is that a good tax system and a good tax administration are vitally important to our economy and to our community. How well we administer the tax laws impacts on the economy and on the social fabric of our society. We are very fortunate in this country in that by and large we have a culture of doing the right thing and the great bulk of Australians voluntarily comply with their tax obligations.

I believe it is critical for a tax administrator to instil high levels of community confidence in its administration. It must do this by:

- operating effectively and efficiently;
- providing excellent service;
- listening to the community and making the task of tax compliance as simple and convenient as possible;
- dealing with people with respect, professionalism and fairness; and
- supporting honest taxpayers that want to do the right thing by having effective deterrent strategies against those who do not.

The complexity of our society is reflected in the laws that govern it, and tax laws are no exception. In the policy debate notions of equity often bring complexity as well. In a self-assessment system, it behoves the administration to help taxpayers or their agents understand their rights and obligations, and to do everything possible to make it easy for people to comply with the tax law.

Following the example of Robert Ewing, my credo is that we must be an externally focused and community driven organisation. By looking at our operations or the implementation of new tax laws from an external perspective, and genuinely listening to taxpayers and taking on board their suggestions, we can enhance the community's trust in our administration and reduce deadweight compliance costs for taxpayers.

My vision is for the ATO to continue to develop as a tax administration that is recognised as world class and which works with the community in the care and management of the tax system. To achieve this, our guiding principles will be consultation, collaboration and co-design. These principles are as follows:

³ Robert Ewing, *Commissioner of Taxation Annual Report*, 10 October 1921.

- we will consult with the community and be responsive to evolving demands;
- we will actively engage the community in administrative design and work very closely with representative bodies to identify problems and to jointly develop solutions where possible; and
- we will play our part in driving improvements for the community through a collaborative approach to whole-of-government initiatives aimed at reducing red tape.

For example, we are currently working with Commonwealth and State agencies to better link our systems via the Australian Business Register so that businesses have a one-stop shop for changing their address and other details.⁴ This also opens the possibility for a single ‘authenticated’ entry point or portal for business to government.

Similarly, we are working with the information technology industry to build software products that help people manage their financial records in a way that reflects the underlying law. These natural systems should make it easier for taxpayers to comply with their tax obligations and further reduce their compliance costs.

We are taking a lead in working with government agencies including the Department of Family and Community Services, Centrelink and the Health Insurance Commission, to make it easier for people to claim their 30 per cent child care rebate and medical expenses and to dramatically ease their compliance burden by pre-populating tax returns with external data.

You will also see high levels of transparency and accountability from the ATO. We are funded by government and accountable to government and parliament in relation to the efficiency, effectiveness and fairness of our operations. This level of accountability is critically important to good tax administration. However, it is also vital that the ATO maintains its independence in the application of the tax law to a particular case. This requires a high level of integrity and courage where the proper application of the law produces an inconvenient result, complemented by advice to government (through Treasury) concerning needed changes to the tax law where such anomalies occur.

We also have the benefit of scrutiny by agencies such as the Australian National Audit Office, the Inspector General of Taxation and the Ombudsman. Constructive scrutiny is to be welcomed and plays a complementary role in improving tax administration.

III GUIDING PRINCIPLES

A Consultation, Collaboration and Co-design

Consultation and the engagement of stakeholders in the care and management of the tax system embeds trust and confidence and so should be the hallmark of a world class tax administration. In Australia, intermediaries such as tax agents have a symbiotic relationship with the tax administration. These intermediaries provide a key leverage point to influence taxpayer behaviour and to facilitate the increase of streamlined online dealings with the ATO.

At the strategic level, it is important that they are capable of carrying out this role and that they are well regulated.⁵

B The Right Mix of Help and Enforcement

The right mix of help and enforcement necessitates the existence of effective deterrence strategies to support those that try to comply with their tax obligations. We have engaged

⁴ See Australian Business Register <<http://www.abr.gov.au>>.

⁵ While the ATO was slow to respond to the mass marketed investment schemes of the 1990s, the emergence of these schemes was attributed in part to deficiencies in the capability and regulation of those that advised the participants.

with the community through our published Compliance Program by making public our analysis of risks to the tax system and encouraging feedback on the choices we have made.⁶

C Assistance for the Tax Profession

Tax agents and the tax profession generally do an excellent job in helping people understand their rights and obligations under the tax law and making it easier for people to meet their tax responsibilities.

In terms of the ATO's immediate priorities, we will seek to provide tax agents with excellent service including:

- a premium telephone service;
- continuing enhancements to the Tax Agent Portal which has revolutionised the practices of many agents and simplified their dealings with us; and
- collaborative and consultative working arrangements so tax agents (and other intermediaries) can provide the best possible services to their clients and continue to make a positive and constructive contribution to the running of the tax system.

A further priority is continuing to support tax agents through Tax Time and we will keep promoting the benefits of online access and lodgement, eLink and tax agent broadcasts. We are encouraging tax agents to use digital certificates and the online access manager to provide greater security and control over use of the Tax Agent Portal. Significantly, we will continue to have the Tax Agent Portal available for registered tax agents 24 hours a day, seven days a week.

Into the future, we will engage constructively with the tax profession to co-design working arrangements with the ATO to best suit their needs, and explore ways of improving capabilities and the effective regulation of the profession. This includes ATO scrutiny of tax agents that operate outside industry norms.

Also, we will continue working with software developers and tax agents to ensure updated legislative and administrative requirements for the new tax year continue to be incorporated into electronic lodgement service software products. It is important for any tax administration to minimise the compliance costs for business and the wider community, subject to the legislative requirements of that system. Where compliance costs outweigh or are disproportionately large relative to the policy intent of any measure, the tax administration can play a role in bringing this to the attention of the government.

D Reducing Red Tape Using Technology

The improvements that the ATO is delivering through the Easier, Cheaper, More Personalised program ('the Change Program') provide an opportunity to reduce red tape. We are investing \$400 million in a major undertaking which will fundamentally change the way we deal with the community, improve our internal processes and update our information technology systems. We see this as a vital investment in running a world class tax administration. The prospect of delivering a greater range of online channels for people to deal with us — and preferably on a whole-of-government basis — is very exciting.

The ATO has introduced services so tax agents and businesses can register for tax, lodge statements and returns, and manage accounts online. We also continued to develop our 'e-tax' online lodgement facility and introduced new services like lodging tax returns over the phone.

⁶ Our annual Compliance Program is available from our website <<http://www.ato.gov.au>>.

The Change Program has already made strides in making it easier and cheaper for people to meet their obligations in a number of respects. The overwhelming majority of tax agents are now using the Tax Agent Portal, and, in a recent survey of agents who use it, 84 per cent said they use the Portal daily and 98 per cent rated it “useful” or “very useful”.⁷ More than 1.3 million Australians are using e-tax to do their annual tax return,⁸ and nearly 40 per cent of business activity statements are being lodged electronically.⁹

The ATO has also upgraded phone services and in 2006, we will be significantly improving the quality of our phone services through the roll out of a new Client Relationship Management System (‘CRM’).

The roll-out of CRM will take place in two stages. The first stage was implemented in 2005 and gave our call centre staff a single consolidated view of taxpayer information and their history, including phone calls and letters. The second stage, due to commence later in 2006, will provide the technology to automatically transfer details of the taxpayer’s enquiry with the call. This should end the frustration people experience when they have to repeat their details if they are transferred to another officer. Once all this technology is introduced, people will not have to go through their full history when they ring and they will not have to repeat their details if they are transferred. Instead, the potential exists for a faster and more efficient service, greater certainty and satisfaction from dealing with a tax officer who understands their situation.

Other major technological improvements we have delivered this year include a secure messaging function so people can send enquiries and requests for tax technical assistance and advice and receive a response via the portals; and a pilot of an electronic record keeping tool so people can load this stored information directly into e-tax.

In May 2006, building on CRM, correspondence will be imaged, tracked and sent electronically to all front-line staff. As well as providing a complete picture of a taxpayer’s client contact history for staff, our people will be able to advise taxpayers of the progress of enquiries and requests as we progressively introduce an organisation-wide case management system. This will enhance our ability to ensure consistent treatment and recording of all dealings with the ATO.

In future years, we will see real-time processing of an increasing number of forms lodged electronically. For example, people will be able to get real-time assessments for lodgements including income tax returns, fringe benefits tax returns, and activity statements. Importantly, people will get an immediate response when lodging these forms online with refunds deposited directly into their bank accounts.

Online forms will be increasingly pre-populated with information held by the ATO and other government and non-government organisations. Forms will also be tailored to a taxpayer’s circumstances. For example, where a taxpayer does not have a GST obligation, they will get a shorter form without the GST boxes.

IV TREATING TAXPAYERS WITH FAIRNESS, INTEGRITY AND HONESTY

Procedural fairness, courtesy and integrity underpin a world class tax administration. This is important because the success of any tax system is highly dependent on people’s propensity to voluntarily comply with their tax obligations.

⁷ In the November 2005 Tax Agent Portal survey conducted by independent researchers, TNS Social Research, 84 per cent of surveyed tax agents said they use the portal daily with 98 per cent rating it as ‘useful’ or ‘very useful’.

⁸ As at January 2006 more than 1.3 million ‘e-tax’ lodgements had been received by the ATO for 2004–05.

⁹ As at January 2006 the number of Activity Statement lodgements via the Business Portal, Electronic Lodgement Service or Electronic Commerce Interface had increased by 3.8 per cent compared to the same time last year to 39 per cent of all activity statement lodgements.

An important factor that shapes community attitudes and behaviour is the community's belief that the Tax Office is fair, certain and legitimate.¹⁰ These perceptions of fairness include:

- the assistance people receive in relation to their responsibilities under the tax system;
- the ease with which people can deal with the Tax Office;
- issues of respect and natural justice; and
- the perceived effectiveness of deterrence strategies.

The recurring themes of excellent service to taxpayers; efficient and effective management of risks to the tax system; making it easier for people to comply; and building community confidence in our tax administration remain our goals today as they were in the past.

Independent professionalism surveys conducted on our behalf suggest that 70 per cent of Australians think that the ATO is doing a good job.¹¹ This is good, but it also suggests that a lot more work is necessary to acquire the confidence and trust in us of the remaining 30 per cent. The surveys suggest that taxpayers are most satisfied that our employees have respect for them, but many believe we need to be more accountable. To address these concerns, the ATO must listen to and respond to community concerns and be more transparent and accountable for our actions.

It is essential that tax officers are competent in their duties and exhibit the professional culture that underpins the Taxpayers' Charter.¹² A tax administration's people can be its greatest asset. It is their professionalism and judgement that influences the views of those that interact with them.

Therefore, the ATO will continue to make a significant investment in our people's capabilities and values, and in ensuring that they are well supported with up-to-date systems and well considered policies and procedures.

V PRIORITIES AND CHALLENGES

I see a number of key priorities as I commence in the role of Commissioner. The ATO's first priority is continuing to deliver on our commitments to the government and the community. This includes effective implementation of new tax law, and maintaining high service standards and high levels of voluntary compliance.

Second, we will be putting a major emphasis on ensuring the effective and efficient delivery of the new service improvements supported by the Change Program. In the implementation stage, there will be some disruptions to our services, and we ask for patience from affected taxpayers and tax agents.

In terms of broad directions the major redevelopment of our technological systems promises an integrated and robust operational platform which should deliver improved levels of service and make taxpayer communication with the ATO easier, simpler and more personalised. It will allow a greater degree of differentiation in the way we deal with taxpayers and their agents.

Third, the work we are doing with the Australian Crime Commissioner, the Australian Federal Police and the Director of Public Prosecutions on tax evasion and abusive tax avoidance schemes, including those that make use of tax havens, should send a strong signal about the firm Commonwealth response that can be expected by the promoters and participants. We are currently working closely with law enforcement agencies on abuses of

¹⁰ ATO, *The Taxpayers' Charter* (2006) available from <<http://www.ato.gov.au>>.

¹¹ Millward Brown, *Community Perceptions Survey* (Millward Brown, June 2005) 35.

¹² ATO, above n 10.

the tax system that appear to be blatant, artificial and contrived. The effective resolution of that work through the courts will send a message that the community does not tolerate egregious tax behaviour. This should reinforce the courts' disallowance of the inflated deductions claimed in mass marketed investment schemes, employee benefit arrangements and wealth optimiser facilities.¹³

Another priority is continuing to demonstrate the highest standards of professionalism, probity and integrity in all our decision making and activities. We have a proud reputation for honesty and we want to keep it that way. I also want to emphasise our commitment to external scrutiny and the value we place on constructive suggestions or criticisms of our operation. We are happy to learn from our mistakes and to improve the quality of the tax administration we provide to the community. However, if we have one plea for external scrutineers, is it that the criticism is constructive, based on fact, linked to viable options for change, and that the excellent features of the administration be endorsed with the same vigour as any perceived shortcomings.

The ATO also faces a number of challenges as we seek to introduce major changes to make it easier for people to do business with us and to help us manage the risks to the tax system. Delivery of the Change Program is not without inherent risks and if we fail to implement it properly, we may limit further opportunities for innovative and value-adding change.

Key economic trends are also likely to influence, or be included by, laws. These include heightened market competition; much greater international mobility of labour, knowledge, and capital, facilitated in part by the continued growth of e-commerce; an ageing population; and increasing emphasis on environmental and energy support concerns.¹⁴

In dealing with risks to the revenue through our compliance strategies (both help and active compliance strategies) it is crucial that we act in a way that continues to instil community confidence. That is why it is so important that we have a publicly articulated compliance strategy, and fair and transparent policies and processes that are a partial answer to the push-back that sometimes seems to follow even the most legitimate use of compliance activities. However, we need to guard against being too defensive and actively listen to the community and constructively address legitimate concerns. To this end, we are refreshing our 'Listening to the Community' program, by seeking to make the best possible use of the wide range of consultative forums that guide us in our operations.

VI CONCLUSION

I am very honoured to have the privilege of leading the administration of Australia's taxation system. It has been said that I am 'passionate about tax'. This is because taxation is a fundamental pillar of our society. While the shape of the tax system is a matter for government and for voters at the ballot box, it is the ATO's responsibility to administer the tax laws in a way that instils community confidence. We have a vision of a world class tax administration that works with the community in the care and management of the community's tax system.

¹³ See for mass market investment schemes: *Howland-Rose v FCT* (2002) 118 FCR 61; *Vincent v FCT* (2002) 124 FCR 350; *Krampel Newman Partners Pty Ltd v FCT* (2003) 126 FCR 561; *Puzey v FCT* (2003) 131 FCR 244; *FCT v Sleight* (2004) 136 FCR 211; *Calder v FCT* (2005] 59 ATR 655; cf *Cooke & Jamieson v FCT* (2004) 55 ATR 183, which is a difficult to explain exception to the rule. See for employee benefit arrangements: *Harris v FCT* (2002) 125 FCR 46; *Elias v FCT* (2002) 123 FCR 499; *Essenbourne Pty Ltd v FCT* (2002) 51 ATR 629; *Kajewski v FCT* (2003] 52 ATR 455; *Jeffery James Prebble Pty Ltd v FCT* (2003] 131 FCR 130; *Walstern v FCT* (2003) 138 FCR 1; *Spotlight Stores Pty Ltd v FCT* (2004) 55 ATR 745. See *FCT v Hart* (2004) 217 CLR 216, in relation to the wealth optimiser.

¹⁴ Australian Tax Research Foundation, 'Background Paper' (Paper presented at the Australian Tax Research Foundation Tax Leader's Forum, Canberra, 5 December 2005) 1.

WHAT'S SEX GOT TO DO WITH IT? TAX AND THE 'FAMILY' IN CANADA

CLAIRE F L YOUNG*

This article considers the tax treatment of spouses and common law partners. It questions whether tax expenditures that take spousal or common law status into account can be justified or whether some or all of them should be eliminated. The article traces the expansion in Canada of the definition of common law partners for tax purposes to include same-sex couples. It examines the political picture and concludes that the federal government had a keen interest in expanding the definition of common law partner for tax purposes because it resulted in a tax windfall for the government and was a key tool in implementing a neo-liberal privatisation agenda. The article concludes that many of the tax rules that take spousal or common law status into account should be repealed. Some rules are inequitable and discriminate against couples with low incomes while others are so inherently flawed and poorly targeted that they do not achieve their policy goals.

I INTRODUCTION

The last 30 years in Canada have seen dramatic changes in the legal definition of 'family' and 'spouse' as well as our social understanding of these relationships. In the 1960s when the Carter Commission recommended that husband and wife be the unit of taxation 'family' consisted of husband and wife together with their children. Non-marital conjugal relationships were not recognised in law. Today in Canada we recognise common law relationships through ascription for many legal purposes. Based on a period of cohabitation, many but not all, of the rights and duties of marriage have been extended to common law cohabitants.¹ Furthermore common law relationships include both heterosexual and same-sex relationships. Most recently, in July 2005 the federal government legalised civil same sex marriage across Canada. Both opposite sex and same sex partners can now choose whether to marry or not; even if they do not, they may still be ascribed spousal status for various purposes, based on a period of cohabitation.

These changes, and in particular, the recognition of same-sex relationships for tax purposes have led me to re-examine how we treat spousal and common law relationships in tax law and policy.² It is important, however, to emphasise that I am not critiquing the inclusion of lesbians and gay men as common law partners. That change was an important part of the struggle for equality and indeed was a milestone in that quest. But, as I have discussed in other work, I argue that we need to rethink the broader issue of why we take marital or familial relationships into account at all for tax purposes.³ I believe that the issue is also one that also has relevance in the

* Associate Dean, Academic Affairs and Professor of Law, Faculty of Law, University of British Columbia, Vancouver, Canada.

¹ 'Common law' is the term used in Canada to describe two people living in a conjugal relationship that is recognized in law for some purposes. The Australian equivalent is 'de facto'.

² Throughout this article I refer to 'spousal and common law relationships'. The Canadian Income Tax Act ('ITA') defines 'spouse' as a married person and 'common law partner' as an individual living in a conjugal relationship with the taxpayer for at least one year.

³ Claire F L Young, 'Taxing Times for Lesbians and Gay Men: Equality at What Cost?' (1994) 17(2) *Dalhousie Law Journal* 534.

Australian context where indications are that the government plans to expand the current tax concessions for families.⁴

My focus in this article is not on the issue of whether the tax unit should be the individual or the married or common law couple.⁵ That issue is one that I believe has been well and truly buried in Canada⁶ and, I would hope, also in Australia. Rather my focus is on those tax rules that currently take spousal and common law relationships into account for a variety of purposes. These include, among others, measures such as tax credits or offsets for dependent spouses, tax expenditures for children and some of the superannuation provisions (Australia) and pension provisions (Canada). My analysis is in three parts. First, I trace some of the recent developments that led to the inclusion of same sex couples as common law partners for tax purposes in Canada. Then I turn to the political picture and consider the government's keen interest in taking familial or spousal relationships into account for tax purposes. Finally, I turn to some of the particular tax rules that take spousal status into account. In a nutshell my question is can they continue to be justified or should we be looking to eliminate all reference to spousal and common law relationships from our tax legislation? My conclusion is that many of these provisions should be removed from the Canadian *Income Tax Act* ('ITA'). The reason that they are no longer valid varies from rule to rule. For example, some rules are inequitable and discriminate without good reason against those couples with low incomes and in favour of those with high incomes. Others, including those that focus on dependency, are inherently flawed and poorly targeted so that they do not achieve their policy goals. Some rules can be critiqued on the basis that they are simply part of a neo-liberal privatisation agenda that encourages individuals to rely on the private family for their economic security. These rules exclude those not in spousal or common law relationships from a variety of very important benefits delivered by the tax system.

II CHANGING DEFINITIONS OF SPOUSE IN CANADA AND THE TAX CONSEQUENCES

In order to place the tax rules in the broader social context of changing definitions of family and spouse, it is important to trace some of these recent changes. Since the 1970s Canada has increasingly recognised common law heterosexual relationships through ascription. As mentioned, the result is that many of the rights and responsibilities accorded to married couples are now accorded to common law couples. During the mid 1990s the *Charter of Rights and Freedoms*⁷ and, in particular the equality provision s 15(1), was used with great success to

⁴ See, eg, 'Tax Breaks Should Go to Families' *The Australian* (Sydney) 20 January 2006, at 2. This article quotes the then Minister for Revenue, Mal Brough, as stating that he made 'no apologies' for the preferential tax treatment for families. Furthermore, Treasurer Peter Costello stated that families would get 'a helping hand in relation to tax and family assistance packages', in the 2006 Budget. See, 'Singled out for Tax Slug' *The Australian* (Sydney) 20 January 2006, 11.

⁵ For an excellent collection of articles on the issue of the appropriate tax unit, see John G Head and Richard Krever (eds), *Australian Tax Research Foundation Conference Series No 16: Tax Units and the Tax Rate Scale* (1996). In particular, see Michael McIntyre, 'Marital Income Splitting in the Modern World: Lessons for Australia from the American Experience' at 1-33 and Neil Brooks, 'The Irrelevance of Conjugal Relationships in Assessing Tax Liability', 35-80.

⁶ For example, see Law Commission of Canada, *Beyond Conjuality: Recognizing and Supporting Close Personal and Adult Relationships* (2001) in which the Commission recommended that 'the individual, rather than the conjugal couple or some other definition of the family unit, should remain the basis for the calculation of Canada's personal income tax', Recommendation 19, 71.

⁷ *Canadian Charter of Rights and Freedoms*, Part 1 of the *Constitution Act 1982* (Canada), enacted as Schedule B to the *Canada Act 1982* (UK), c 11, ('the Charter').

challenge heterosexist definitions of spouse. The result is that since the mid 1990s, same-sex couples have increasingly — though unevenly across the provinces — been treated as common law couples. In 1999, the Supreme Court of Canada rendered the most important judicial decision to date on same sex spousal recognition in *M v H*,⁸ striking down as unconstitutional a definition of ‘spouse’ in a family law statute that had been limited to opposite sex cohabitants. The result was that lesbians and gay men could now sue each other for spousal support on the breakdown of their relationships. This case generated many legislative changes at both federal and provincial levels to extend spousal or equivalent status to same-sex cohabitants.⁹

Meanwhile on the tax front, the Ontario Court of Appeal had held in 1998 in *Rosenberg v Canada (Attorney-General)*¹⁰ that the words ‘or same-sex’ should be read into the definition of ‘spouse’ in the *ITA*, for the purposes of registration of pension plans. The case was brought by two women who worked for one of Canada’s large unions, the Canadian Union of Public Employees (CUPE). CUPE had a standard employment pension plan which included a provision for survivor benefits. Pension plans in Canada are heavily subsidised by the tax system, with deductions for contributions by employers and employees, and sheltering from tax of all income earned by the plan until the pension is received. In order to qualify for these subsidies the plan must accord with the requirements of the *ITA* and that included a definition at that time of spouse that was restricted to heterosexual couples. CUPE decided to extend its plan to its lesbian and gay employees on the same terms as it applied to its heterosexual employees but the government refused to accept this amendment. By reading the words ‘or same-sex’ into the definition of spouse in the *ITA* for the purpose of pension plans the court effectively extended entitlement to survivor benefits under occupational pension plans to the partners of lesbians and gay men who die while covered by the plan.¹¹ Interestingly, unlike other cases involving successful *Charter* challenges on the basis of sexual orientation, the federal government did not appeal this decision.

Both the *M v H* and *Rosenberg* had other far-reaching consequences. In 2000 the federal government enacted the *Modernization of Benefits and Obligations Act*¹² which amended 68 pieces of legislation to include same-sex couples in an array of laws that assign rights and responsibilities based on spousal status. Sections 130-46 of the *Modernization of Benefits and Obligations Act* amended the *ITA* to redefine spouse to include married persons and to add a new definition of common law partner which includes a person cohabiting in a conjugal relationship with the taxpayer for a period of at least one year.¹³ Meanwhile the Law Commission of Canada launched a major research project titled ‘Beyond Conjuality: Recognizing and Supporting Close

⁸ *M v H* [1999] 2 SCR 3.

⁹ For example, the *Definition of Spouse Amendment Act*, SBC 1999, c 29; the *Definition of Spouse Amendment Act*, SBC 2000, c 24; *An Act to Amend Certain Statutes because of the Supreme Court of Canada’s Decision in M v H*, SO 1999, c 6.

¹⁰ *Rosenberg v Canada (Attorney-General)* (1998) 38 OR (3d) 577.

¹¹ For an in depth analysis of this case, see Claire F L Young, ‘Spousal Status, Pension Benefits and Tax: *Rosenberg v Canada (Attorney-General)*’ (1998) 6 *Canadian Labour and Employment Law Journal* 435.

¹² *Modernization of Benefits and Obligations Act*, SC 2000, c 12.

¹³ Section 248 of the *ITA* provides that ‘common law partner’ with respect to a taxpayer at any time, means a person who cohabits at that time in a conjugal relationship with the taxpayer and (a) has so cohabited with the taxpayer for a continuous period of at least one year, or (b) would be the parent of a child of whom the taxpayer is a parent, if this Act were read without reference to paragraphs 252(1)(c) and (e) and subparagraph 252(2)(a)(iii), and for the purposes of this definition, where at any time the taxpayer and the person cohabit in a conjugal relationship, they are, at any particular time after that time, deemed to be cohabiting in a conjugal relationship unless they were not cohabiting at the particular time for a period of at least 90 days that includes the particular time because of a breakdown of their conjugal relationship.

Personal Adult Relationships’ which entailed a ‘fundamental rethinking of the way in which governments regulate relationships’.¹⁴ In brief it concluded that governments rely too heavily on conjugal, as in marital, and common law relationships in accomplishing state objectives. The Law Commission of Canada suggested that the government re-evaluate the way in which it regulates relationships and devised a four part methodology to be facilitate this re-evaluation. Two questions posed by this new methodology were, ‘Do relationships matter? If the law’s objectives are sound, are the relationships included in the law important or relevant to the law’s objectives?’¹⁵ The Law Commission’s research paper reviewed a variety of pieces of federal legislation, including the *ITA*.

In the early 21st century, a renewed struggle for same-sex marriage emerged, having been put on hold in Canada in the mid-1990s in favour of seeking the rights available to unmarried opposite sex cohabitants. Several successful *Charter* challenges were raised to the common law rule that defined marriage as between one man and one woman.¹⁶ As a result, same-sex couples acquired, with startling rapidity, the right to marry in several provinces and one territory. In October 2004, the federal government sought the opinion of the Supreme Court of Canada on the question of whether same-sex marriage for civil purposes was consistent with the *Charter* and on 19 December 2004 the Supreme Court of Canada held that it was.¹⁷ On July 20, 2005, Bill C-38, the *Civil Marriage Act* received Royal Assent and was proclaimed into law, legalising civil same-sex marriage across Canada. Civil marriage in Canada is now defined as ‘the lawful union of two persons to the exclusion of all others.’

Without diminishing the struggle that lesbians and gay men have endured to secure legal recognition of their relationships, or its potential to challenge heterosexual norms and definitions of family, I argue that the recent tax changes in Canada to include same-sex couples as common law partners have done nothing to challenge the socio-economic inequalities embedded in the tax rules that apply to spouses and common law partners. Indeed expanding the definition of those who are treated as spouses for tax purposes has simply reinforced those inequalities. It is time to revisit and rethink why we take spousal and common law relationships into account for tax purposes. Other than the recent work of the Law Commission of Canada¹⁸ which was part of a larger project examining the numerous laws that take spousal status into account, no attention has been paid by legislators over the last four decades to the fundamental tax policy question of why we take spousal and common law relationships into account for certain tax purposes and whether such a policy can be justified.

While many see the federal government’s decision to enact the *Modernization of Benefits and Obligations Act* and thus expand the group accorded common law status for tax purposes as progressive, we need to be cautious. Certainly there is an assumption by many that it is to their advantage to be treated as spouses and common law partners for tax purposes.¹⁹ There is a sense

¹⁴ Above n 6, ix.

¹⁵ *Ibid*, xii.

¹⁶ See, eg, in Ontario, *Halpern v Canada (Attorney-General)* (2003) 169 OAC 172 (CA); in British Columbia, *EGALE Canada Inc v Canada (Attorney-General)* (2003) 228 BCCA 406.

¹⁷ *Reference re Same-Sex Marriage* [2004] 3 SCR 698.

¹⁸ Above n 6.

¹⁹ The author spoke with several groups of lesbian and gay individuals about the impact on them of the changes to the definition of spouse in the *ITA* and generally speaking most of those individuals believed that they would benefit from the change, even though in reality the result of the change was that many of them would pay more tax than they were currently paying.

that there are more tax breaks for couples and that the tax bill of a couple will be lower than it would be if they were taxed as individuals. As I have demonstrated in previous work, this is not necessarily true.²⁰ In fact the impact of being treated as spouses or common law partners varies according to three factors: the amount of income of each of the partners, the nature of that income and the relative distribution of that income as between the partners. As I shall discuss in more detail later, generally speaking, in Canada the couple in which there are two low rate taxpayers pays more tax when they are treated as a couple rather than as individuals. The couple in which there are two high rate taxpayers and the couple in which one person is a high rate taxpayer and the other has little or no income both tend to benefit in terms of taxes saved when treated as a couple.

Canada has a self-assessing income tax system. If one meets the common law partner test of living in a conjugal relationship for one year, one must declare that status on the tax return and that status is ascribed to you with the result that all the rules that apply to common law partners apply to you. There is no choice in the matter. Thus it is extremely important that the rules that take spousal status into account operate in a fair and efficient manner.

In this article I focus on two distinct aspects of these recent developments. First, I contend that the government's decision not to appeal *Rosenberg*, and its willingness to include same-sex couples as common law partners for tax purposes was a pragmatic political decision, a decision that was not based on any analysis of the change from a tax policy perspective. As I shall discuss in more detail, such a change resulted in a tax windfall for the federal government in terms of the amount of tax collected. Much of the windfall was due to a reduction in the amount of tax credits available to common law partners, a reduction that resulted from the aggregation of income when determining entitlement to those credits. At the same time including same-sex couples as common law partners accords perfectly with the neo-liberal agenda of privatisation of the economic security of citizens. That is the tax system is increasingly being used to encourage individual family members to provide care for each other, thereby relieving the state of its responsibility.

III THE POLITICS OF IT ALL

A *The Tax Windfall*

Income tax law is one of the most important political tools that a government has at its disposal. Tax laws are used to direct economic and social behaviour in a myriad of different ways. Many of the most important measures we use to achieve social policy goals are tax expenditures. Tax expenditures are defined as any deviation from the benchmark personal income tax structure. They include measures such as deductions in the computation of income, tax credits, exemptions from tax and deferral of tax payable. Tax expenditures are the functional equivalent of direct government expenditures with one main difference. Instead of being delivered as a direct grant to an individual, tax expenditures are delivered by the tax system. The distinction is significant. While we tend to analyse the impact of a technical tax provision by reference to criteria such as horizontal and vertical equity, neutrality and simplicity, we apply different criteria to a tax expenditure. As the Law Commission of Canada has said: 'Could the objective be better served through the use of some other government policy instrument?'²¹ To

²⁰ Above n 3.

²¹ Above n 6, 65.

this question I would add, is the measure fair or does it discriminate in an inappropriate manner against some taxpayers and in favour of others? Whether a particular measure is a technical tax rule or a tax expenditure has been the subject of much debate. Each year Canada publishes a list of all tax expenditures and their cost.²² For Canadian purposes the benchmark for the personal tax system, that is those rules that are not considered to be tax expenditures, includes the tax rates and brackets, the unit of taxation, the taxation period (the calendar year), the treatment of inflation and the constitutional immunity from taxation of Canada and the provinces.²³ All other measures are tax expenditures or memorandum items.²⁴

As mentioned, inclusion of same-sex couples as common law partners for tax purposes resulted in a tax windfall for the government because some individuals were required to pay more taxes when treated as part of a couple than they previously paid as individuals. While the federal government has not published the amount of this windfall, history tells us that the windfall can be considerable. In 1993, when the federal government amended the definition of spouse to include 'common law' heterosexual spouses, the Department of Finance estimated that the change would result in increased tax revenues over a 5 year period of \$9.85 billion.²⁵ The primary reason for the increased tax revenues is attributable to the rules that require the aggregation of the incomes of spouses and common law partners for the purpose of computing entitlement to the refundable GST tax credit and the Canada Child Tax Benefit. Entitlement to both these tax credits depends on one's level of income and as income increases the amount of the credit is reduced and eventually phased out completely. Therefore, for example, two individuals with incomes of \$20,000 who are now included as common law partners will lose entitlement to either all or part of these refundable tax credits. The impact of this change is especially harsh on those with low incomes, the very group the tax credits are intended to benefit. There is also a gendered impact. Given that women tend to earn less than men and have lower incomes, it is likely that more women than men will lose these credits.²⁶

B *The Privatisation Agenda*

One of the cornerstones of neo-liberalism is an increased reliance on the private sector, including the private family and the private market, rather than the state, to provide for the welfare of citizens. As Lisa Philipps has said 'the drive towards privatization in Canada has at its heart one central claim: that private choice is better than public regulation as a mechanism for allocating resources and ordering social affairs'.²⁷ Increasingly in Canada the law, and in this context tax law, is being used as a tool of privatisation.²⁸ Tax expenditures in particular are often used as a private mechanism to achieve social or economic goals. That is, while we see the state as 'public' in contrast to the private market or family, by using tax expenditures delivered to the

²² For the most recent account see, Canada, Department of Finance, *Tax Expenditures and Evaluations 2005* (2005).

²³ See Canada, Department of Finance, *Tax Expenditures: Notes to the Estimates/Projections 2004* (2004).

²⁴ Memorandum items include, among others, items 'for which there may be some debate over whether they should be considered tax expenditures', *ibid*, 7.

²⁵ Department of Finance, Canada, *Budget Papers: Supplementary Information* (25 February 1992), 138-9.

²⁶ In Canada, women who work for a full year, full time earn 73 cents for every dollar earned by men, see, Cindy Wiggins, 'Women's Work: Challenging and Changing the World' (Paper presented at the Canadian Labour Congress Women's Conference, 25 May 2003) <<http://canadianlabour.ca/updir/workwomenen.pdf>>.

²⁷ Lisa Philipps, 'Tax Law and Social Reproduction: The Gender of Fiscal Policy in an Age of Privatization' in Brenda Cossman and Judy Fudge (eds) *Privatization, Law and the Challenge to Feminism* (2002), 41.

²⁸ For a detailed discussion of the role of law in the drive towards privatization see Cossman and Fudge, *ibid*, 30-6.

private sector to reinforce private responsibilities the state is to a certain extent abdicating its public responsibility for that social or economic goal.

In this article, I focus on just one aspect of that privatisation, that is the trend to place responsibility on individual family members to provide care for each other, thereby relieving the state of its responsibility in that regard. That 'care-giving' can take many forms including the actual care-giving of the elderly and disabled and the economic support of family members. My contention is that by taking spousal and common law partner status into account with respect to entitlement to and allocation of a variety of tax expenditures, the tax system is one important tool in this privatisation.

One Canadian example of this privatisation may also have resonance in Australia. The Canadian government has made it clear that the future for Canadians in terms of their economic security in retirement is to contribute to private pension plans such as occupational pension plans (Registered Pension Plans, RPPs) personal plans (Registered Retirement Pension Plans, RRSPs) and not to rely on the more universal Old Age Security (OAS) or the Canada Pension Plan (CPP).²⁹ As a result these private plans are heavily subsidised by tax expenditures, including tax deductions for contributions to the plans, and a sheltering of all income earned by the plan from tax until either the contributions are withdrawn or the plan matures. The value of these tax expenditures is a staggering \$31 billion for 2005, making tax expenditures for retirement savings the single largest tax expenditure in Canada.³⁰ The situation in Australia is similar to that in Canada. The superannuation system is heavily subsidised by the tax system, although the nature of the tax expenditures is a little different from that in Canada. Tax concessions for superannuation in Australia constitute the largest single tax expenditure, estimated at \$12.76 billion for 2004-5.³¹

At a general level, the major problem for many is a lack of access to these plans. This is especially true for women whose lack of participation in the paid labour force in comparison to that of men means that many women are excluded from these plans.³² In addition, the kind of work that women do is a major factor. Only those who work for relatively large employers, economically able to provide a pension plan, will benefit. Those who work part-time, in non-unionised jobs, or for small employers unable to finance these plans do not benefit. In Canada women have consistently formed 70 per cent of the part time labour since the mid 1970s.³³ Similarly in order to access RRSPs, one must have the discretionary income to make the contribution. Given that women earn less than men it is not surprising that more men than women make these contributions and thereby benefit from the tax expenditure.³⁴

²⁹ The Old Age Security is a non-contributory plan consisting of a flat rate monthly sum paid to those over 65, although as income increases there is a clawback through the income tax system of part of the pension. Nevertheless it is the most 'universal' pension plan in Canada. The Canada Pension Plan is a contributory income replacement plan and benefits are based on labour force participation. Both these plans are described as 'public' pensions in contrast to the private RPPs and RRSPs.

³⁰ Above n 21 at Table 1.

³¹ See Miranda Stewart, 'Are You Two Interdependent? Family, Property and Same-sex Couples in Australia's Superannuation Regime' (2006) 28 *Sydney Law Review* 437.

³² Only 57 per cent of women over 15 are employed in Canada, compared to 68 per cent of men (latest figures available), see Housing, Family and Social Statistics Division, 'Women in Canada: Work Chapter Updates' (2004) <<http://www.statcan.ca/english/freepub/89F0133XIE/89F0133XIE2003000.pdf>> 29 September 2006.

³³ *Ibid.*

³⁴ Above n 26.

To a certain extent the government has recognised and attempted to remedy women's unequal access to private pension plans and the accompanying tax subsidies. Consequently, the *ITA* permits contributions to a 'spousal' RRSP. A taxpayer may contribute, up their own maximum limit,³⁵ to a plan in their spouse or common law partner's name and receive the same tax benefits that they would have received had they made the contribution to their own plan. Thus, there is the opportunity to establish a pension plan for one's spouse or common law partner and the ability to income split with that person by diverting future income to them. The advantages can be significant where the spouse or common law partner has little or no other income when they retire. Similarly in Australia the splitting of superannuation contributions between spouses is permitted effective 1 January 2006.³⁶

While the Canadian 'spousal' RRSP and the ability to split superannuation contributions in Australia are well intentioned measures, they remain a highly private and limited response to a public issue, that is women's lack of access to pension and superannuation plans. This lack of access in turn contributes to the fact that so many elderly women live in poverty.³⁷ Essentially the private family is encouraged to provide for its own economic security in retirement, albeit with a tax break to encourage it to do so. But many cannot take advantage of this opportunity. Low income taxpayers may not have the discretionary funds to contribute on their spouse's behalf. Additionally single women have no access to this expenditure. Given that 43 per cent of single women over 65 live below the poverty line compared to 5 per cent of women over 65 who have a spouse, it appears that the subsidy is being misdirected.³⁸ By linking this tax expenditure to spousal status, the government is directing the benefit to a very limited group of people, a group that may not be the neediest. Furthermore, in Canada at least, statistics show that fewer people than ever are living in a married or common law relationship.³⁹ As the Women and Taxation Working Group of the Ontario Fair Tax Commission stated 'the concept of a couple as a life-long economic unit with joint income, wealth, and expenses may no longer be appropriate given changing family structures, increasing divorce rates, and falling marriage rates'.⁴⁰

There is another important tax break with respect to private pensions that is only available to those in a spousal or common law relationship. If a taxpayer dies the funds in their unmatured RRSP may be transferred on a tax-free basis to their spouse or common law partner provided the spouse or common law partner contributes that amount to their own RRSP.⁴¹ In Australia, a tax exempt death benefit from a superannuation fund may be paid to a person who was in an 'interdependency relationship' with the deceased. The definition of 'interdependency relationship' would include a person who was married to or a de facto spouse of the deceased.⁴² The tax advantages of these rules are significant because, for example, in Canada without the

³⁵ For 2005, the limit is \$16,500.

³⁶ *Taxation Laws Amendment (Superannuation Contribution Splitting) Act 2005 (Cth)*.

³⁷ In Canada, 71 per cent of those over 65 living below the poverty line in 2000 were women, Statistics Canada, 'Analyzing Family Income' (2001) <<http://www12.statcan.ca/english/census01/products/analytic/companion/inc/analys.cfm>>.

³⁸ *Ibid*.

³⁹ Statistics Canada, '2001 Census: Marital Status, Common-Law Status, Families, Dwellings and Households' *The Daily*, 22 October 2002 <<http://www.statcan.ca/Daily/English/021022/d021022.pdf>> at 29 September 2006.

⁴⁰ Ontario Fair Tax Commission, Women and Tax Working Group, *Women and Taxation* (1992), 22.

⁴¹ The rules in the *ITA* are quite complex and certain conditions must be met. The rollover also applies with respect to a transfer to a child or grandchild of the deceased who was financially dependent on the deceased at the time of death.

⁴² Section 27AAB of the *Income Tax Assessment Act 1936 (Cth)*.

rollover the fair market value of the property held in the RRSP would be included in income in the deceased's terminal year. Once again, however, we are using the tax system to encourage the private family to provide for the economic security of its members. We are directing significant tax subsidies to a very limited group of people, a group that statistics tell us may not be the most in need.

As I have demonstrated reliance on the private sector for the economic security of individuals is problematic for a variety of reasons. At a general level such privatisation policies tend to diminish the role that the state plays in ensuring a fair level of income for all its citizens. The state is delegating its responsibility to the private sector, with virtually no strings attached. Encouraging the private family to fill the role previously taken by the state leaves gaps in the social security network, gaps which those without spouses or common law partners often fall through. The result is often a retirement lived in poverty. The current privileging of private pension plans also reduces the resources available for the more universal state pensions, pensions on which women in particular depend for their economic security in retirement.⁴³

Various suggestions for remedying some of the problems I have discussed have been made in the past.⁴⁴ These suggestions range from a total removal of all tax preferences for private pension plans to a revamping of the current tax rules to try to make them more equitable. In the context of this discussion about the tax preferences for spouses and common law partners, I suggest that all of these rules be repealed. Applying tax expenditure analysis to these provisions, one can conclude that they are not the best way to achieve the policy goal of ensuring that Canadians, and women in particular, are economically secure in their retirement. As I have discussed, they are too limited in scope and benefit some at the expense of others with no rational justification for that discrimination.

IV OTHER SPOUSAL TAX EXPENDITURES

A *The Dependent Spouse and Common Law Partner Credit*

The spousal and common law partner tax credit is available to a taxpayer who supports their spouse. Put simply, the taxpayer is entitled to a tax credit of just over \$1,000 which is reduced in amount if the spouse or common law partner's income exceeds approximately \$680, with the credit being eliminated once the spouse or common law partner's income exceeds approximately \$7,000. In Australia there is a similar provision, namely the Dependent Spouse Tax Offset. This provision provides a tax offset of \$1,610 for 2005/6 with the offset being eliminated once the spouse's income exceeds \$6,722. It should be noted, however, that this provision is more limited in application than the Canadian spousal or common law partner tax credit. As the Law Commission of Canada has said of the Canadian credit, it 'appears to be designed to promote economic dependency in conjugal relationships'.⁴⁵

⁴³ During the past 20 years, 99 per cent of the income gain of the 10 per cent of elderly women living alone with the lowest incomes was from higher direct government payments. For the 20 per cent of women in the middle of the income distribution, direct government transfers accounted for more than 80 per cent of their gain, see Statistics Canada, 'Analyzing Family Income' (2001) <<http://www12.statcan.ca/english/census01/products/analytic/companion/inc/analys.cfm>>.

⁴⁴ For a more detailed description of some of the recommendations, see Claire F L Young, *Women, Tax and Social Programs: The Gendered Impact of Funding Social Programs through the Tax System, Status of Women, Canada* (2000) 48-51.

⁴⁵ Above n 6, 74.

There have been many critiques of the Canadian spousal and common law partner tax credit.⁴⁶ First, because more women than men work in the home and not in the paid labour force it is men who predominantly claim the spousal and common law partner tax credit. Several issues arise when one considers the impact on women of provisions such as the spousal and common law partner tax credit. Provisions based on dependency are a disincentive to women's participation in the paid labour force. When the tax costs such as the loss of the credit are taken into account, there is a real disincentive to women in spousal or common law relationships entering the paid labour force. This disincentive is exacerbated by other costs incurred by women who choose to work outside the home, such as child care costs, travel costs, clothing and the monetary and non-monetary costs associated with replacing the household labour. Furthermore, when one considers that many women are the secondary earners in their relationships, and that they work for relatively low wages, the combination of these factors and the loss of the tax credit have a particularly detrimental effect on women's choice to work outside the home.

Another important critique of dependency provisions is that rules like the spousal and common law partner tax credit affirm that a woman's dependency on man deserves tax relief. Again, this undermines the autonomy of women and it results in a certain privatisation of economic responsibility for dependent persons. Tax policy has responded to women's lack of economic power by leaving it to the family (the private sector) to assume responsibility for women's lack of resources. Furthermore, the tax subsidy is delivered to the economically dominant person in the relationship and not the 'dependent' person who needs it. This manner of delivery assumes that income is pooled and wealth distributed equally within the relationship. However research has shown that such pooling is not the norm in relationships, with one study demonstrating that it only occurs in one fifth of households surveyed.⁴⁷ Many women do not have access to or control over income earned by their spouse and predicating tax policies on the assumption that they do is unfair.

The spousal and common law partner tax credit is a measure that can be viewed as one that gives public recognition to the work done by women in the home. Indeed it is the only measure (tax or otherwise) that places a 'value' on household labour. But if it is intended to recognise the contribution made by those who work in the home then, as mentioned above, the tax credit should go to the person who performs that labour and not the person who benefits from it. Further, viewing the tax credit as a measure that values household labour is problematic. Because the 'value' placed on the labour is so low, the measure can only be considered to reinforce the perception that household labour, including child-care has little value. That in turn contributes to the under-valuation of work such as child-care, even when it is performed in the open market, as evidenced by the low salaries paid to child-care workers.

Another justification for the spousal or common law partner tax credit is that it recognises the reduced ability to pay tax of an individual who supports a person who is economically dependent on them. But this argument is not persuasive. It ignores the benefit that accrues to the individual from work performed in the home, such as housework and child-care, by the person whom they support. Indeed this home labour may well increase the ability to pay of the individual because

⁴⁶ See, eg, Law Commission of Canada, which recommended that the spousal tax credit be repealed and replaced with 'enhanced or new programs that more carefully target caregivers and children': *ibid*, 77. See also Claire F L Young, *What's Sex Got To Do With It? Tax and the 'Family'*, Report for Law Commission of Canada (2000). Much of the following material is based on that research report.

⁴⁷ Carolyn Vogler and Jan Pahl, 'Money, Power and Inequality within Marriage' (1994) *Sociological Review* 263, 285.

there is no need to have recourse to the private market in order to obtain the services provided in the home by the spouse who is supported by the individual. This point was not lost on the Canadian Royal Commission on the Status of Women in 1970 when it rejected the Carter Commission recommendation that the family be the unit of taxation. At that time the Royal Commission on the Status of Women noted that ‘in most cases the wife who works at home as a housekeeper, far from being a dependent, performs essential services worth at least as much to her as to her husband as the cost of food, shelter and clothing that he provides for her’.⁴⁸ Given all these problems it is not surprising that various individuals and organisations have called for the repeal of the spousal or common law tax credit.⁴⁹

As mentioned earlier in this article, the impact of the rules that take spousal or common law status into account varies depending on the level of income of the spouses or common law partners and the distribution of income within the relationship. There is no question that those couples with high incomes and significant wealth can benefit tremendously from some of the tax rules. One example is the ability to transfer capital property to your spouse or common law partner on a tax-free basis, either *inter vivos* or on death. Canada’s tax treatment of capital differs from that of most other jurisdictions. There are no estate taxes, succession duties or gift taxes in Canada. Rather when capital property is transferred from one person to another, either by way of a gift or bequest, the general rule is that the transferor is deemed to have disposed of the property at fair market value.⁵⁰ The result is that if the fair market value of the property at the time of transfer is more than the cost of the property to the transferor, a capital gain arises and one half of the gain is included in the transferor’s income. A significant exception to this rule is that if the transfer is to a spouse or common law partner a rollover of the property occurs, so that the taxpayer is deemed to dispose of the property for proceeds of disposition equal to their cost for the property and the spouse or common law partner is deemed to acquire the property at an amount equal to those proceeds of disposition. The result is a significant deferral of tax until the spouse or common law partner ultimately disposes of the property. The rollover is available both on an *inter vivos* basis and on death and is also available with respect to a transfer to a former spouse or former common law partner in settlement of rights arising from the marriage or common law partnership.⁵¹

These rules serve a variety of purposes. From a practical perspective, if transfers between spouses were taxable events, the Canada Revenue Agency (CRA) would have to trace all such transactions in order to ensure that any tax owing was paid. Given the informal context in which these transactions occur, such a task would be difficult. Another problem is that because these transactions do not take place in the open market, there may be a liquidity problem with no cash available to pay the tax. The rollover rules are also intended to encourage the redistribution of property within the relationship, especially from men, who tend to own more capital property than women, to their spouse or common law partner. It is questionable, however, how effective they are in this regard. There are many reasons why an individual may choose not to transfer

⁴⁸ Canada, Royal Commission on the Status of Women in Canada, *Report* (1970), 293-4.

⁴⁹ See, eg, the Law Commission of Canada, above n 6, 77; Maureen Maloney, ‘What Is The Appropriate Tax Unit for the 1990s and Beyond?’ in Allan Maslove (ed) *Issues in the Taxation of Individuals* (1994) 146; Young, above n 45, 113.

⁵⁰ Section 69 of the *ITA*.

⁵¹ Section 70(6) of the *ITA* provides the rollover for transfers as a consequence of death to a spouse or common law partner or to a spouse trust and ss 73(1) and (1.01) of the *ITA* provide the rollover for *inter vivos* transfers to a spouse or common law partner.

property to their spouse on an *inter vivos* basis, including concern about transferring control of that property to the spouse or common law partner. These rules are also affected by the operation of the attribution rules. If capital property that is transferred to a spouse or common law partner at less than fair market value generates income, that income is attributed to the transferor and not taxed to the spouse or common law partner, thereby preventing income splitting with respect to income from property.⁵² Given that most of these transfers are presumably gifts, the attribution of income may well operate to deter taxpayers from entering these transactions.⁵³

It is impossible to determine whether the rollover rules do encourage the redistribution of wealth on an *inter vivos* basis in spousal and common law relationships. While CRA classify these provisions as tax expenditures, they do not put a value on the expenditures because ‘the data is not available to support a meaningful estimate/projection’.⁵⁴

These rules can be critiqued on a variety of bases. First, they only benefit those couples with considerable wealth who own capital property. In the absence of gift taxes or estate taxes, these rules provide a huge benefit to those couples because there is no taxation of any appreciation in the value of the capital property owned by the couple so long as it is owned by either of the spouses or common law partners. Second, while it may be difficult to trace intra spousal *inter vivos* transfers, the same cannot be said of transfers on death where the will or other documents relating to probate or intestacy will provide information about the transfer.

The rollover rules are predicated on an assumption of economic interdependence⁵⁵ and economic mutuality, that is, what is mine is yours and what is yours is mine. Yet not all spousal and common law relationships are founded on economic interdependence, nor is there an economic mutuality within the relationship with respect to property. Thus the rollover rules can be said to be over inclusive. They are rules that apply in situations which do not reflect their underlying policy. This problem led the Law Commission of Canada to recommend the extension of the rules to all persons living in economically interdependent relationships.⁵⁶ I disagree with their recommendation and believe that the *inter vivos* rules, at least, should be repealed outright. First, as mentioned above the application of the attribution rules may deter taxpayers from entering into these transactions, thereby obviating the need for the rollover rules. Secondly, tracing problems are not unique to intra spousal or common law partner transfers. Transfers to adult children or close friends can be difficult to trace. Furthermore, the *ITA* provides for a self-assessing system in which taxpayers are required to declare a variety of transactions that cannot always be traced, including gifts to third parties. Finally, there is of course, always the problem of defining ‘interdependence’ if one chooses to expand the group eligible for the tax break.

B Provisions that are Based on an Assumption of Economies of Scale in Relationships

Some of the provisions that apply to spousal and common law relationships take into account the economies of scale in terms of consumption and household production that are assumed to

⁵² *ITA* s 74.1.

⁵³ *ITA* s 74.2 also provides that a transfer of capital property to a spouse or common law partner must be at fair market value in order to avoid the attribution of any capital gain arising from that transfer to the transferor when the spouse or common law partner disposes of the property.

⁵⁴ Department of Finance, above n 22, 15.

⁵⁵ The Law Commission of Canada described economic interdependence as the ‘raisin d’être of the rollover rules’, above n 6, 89.

⁵⁶ *Ibid* recommendation 25.

arise from spouses and common law partners living together. These economies of scale arise from sharing the cost of certain items, such as rent, household expenses, including durable consumer assets such as furniture and kitchen appliances as well as the benefits from shared household work. The theory is that the savings from these shared expenses and labour increase a taxpayer's ability to pay tax. In some instances the assumption of an enhanced ability to pay means that entitlement to certain tax credits and deductions is reduced for the couple. For example, the child-care expense deduction provides a deduction in the computation of income of a limited amount of child care expenses.⁵⁷ In spousal or common law relationships, however, the deduction must be taken by the taxpayer with the lower income. This rule effectively reduces the value of the deduction because that value is tied to the rate at which tax is paid with high rate taxpayers saving more in terms of taxes payable than low-rate taxpayers.

Other provisions take into account the assumed increased ability to pay that flows from economies of scale by aggregating the incomes of spouses and common law partners for the purposes of determining entitlement to tax credits. For example, the GST tax credit is intended to compensate low-income individuals for the regressive impact of the 7 per cent GST. The credit is a refundable credit of \$227 for individuals. Because it is targeted at low income individuals, it is phased out by 5 per cent of the individual's income over approximately \$30,000. However, the income of spouses and common law partners is aggregated for the purpose of computing entitlement to the GST tax credit with the result that the amount they receive as a couple will be less than they received as two individuals.⁵⁸ In addition, spouses and common law partners are only entitled to the basic GST credit, while in certain circumstances individuals may also receive an additional credit. As mentioned earlier, this reduction in the amount of the GST credit is one of the reasons that the inclusion of lesbians and gay men as spouses resulted in a tax windfall for the government.

The issue of aggregating the income of families or spouses when determining entitlement to tax credits, or indeed any transfer program such as the Family Tax Benefit in Australia, is complex. But to the extent that this is based on an assumption of economies of scale, it is highly problematic. First, economies of scale arise in a variety of situations other than spousal or common law relationships. As the Law Commission of Canada noted, 'even if consumption economies exist when individuals live together and share resources, and even if one takes the view that they should be taken into account in government transfers, conjugal cohabitation has become an increasingly poor proxy for the identification of such economies'.⁵⁹ Many others such as students or good friends share accommodation and the associated expenses. The tax system takes no account of their economies of scale when determining entitlement to tax credits. In addition, individuals enter into all kinds of arrangements that produce economies of scale, such as car pooling, sharing a baby sitter for their children, recycling consumer durables by passing them on to a friend when new purchases are made. Again the tax system takes no account of these transactions. Given that it is virtually impossible to identify when household economies arise or to define the nature of the relationships in which they do arise, tax provisions should not be based on an assumption that such economies exist and enhance the ability to pay of spouses and common law partners.

⁵⁷ *ITA* s 63.

⁵⁸ The Law Commission of Canada noted that the 'GST credit received by each member of a cohabiting couple is reduced to about 65 per cent of the amount that would be received by them as individuals', above n 6, 79-80.

⁵⁹ *Ibid* 80.

I agree with the Law Commission of Canada which concluded that ‘income security programs should not assume that the benefits of individual income are always shared with others in conjugal relationships and that sharing never occurs in other relationships’⁶⁰ and share their view that entitlement to tax credits such as the GST tax credit should be determined by reference to individual income and not spousal or family income.

V CONCLUSION

In this article I have used the recent developments in Canada to extend the definition of spouse in the *ITA* to include lesbians and gay men as a catalyst to rethink why we take spousal relationships into account at all for tax purposes. In no way do I intend to diminish the remarkable struggle of lesbians and gay men for equality, but I do argue that the consequences of attaining spousal status for tax purposes has had a negative impact on many because of a reduction in the value of some tax expenditures, which in turn has meant an increase in the amount of tax they are required to pay. The negative consequences are both classed and gendered with those with lower incomes, and women in particular, bearing their burden. The result is a reinforcement of existing inequities which privilege those with high incomes at the expense of those with low incomes. Tax expenditures that take spousal status into account must operate in a fair, equitable and efficient manner and as I have discussed many of the current tax rules offend these basic tax policy principles. I believe that it is time to take the report of the Law Commission of Canada seriously and consider repealing many of the tax rules that take spousal status into account.

⁶⁰ Above n 6, 82.

AN OLD TAX IS A SIMPLE TAX: A BACK TO THE FUTURE SUGGESTION FOR THE SIMPLIFICATION OF AUSTRALIAN CORPORATE-SHAREHOLDER TAXATION

C JOHN TAYLOR*

The system of corporate-shareholder taxation adopted in the Income Tax Assessment Act 1915 (Cth) was both elegant and simple. Dividends paid out of current year income were deductible to the company and assessable to shareholders. Where dividends were paid out of taxed retained income, shareholders received a credit (but not a gross up) for corporate tax paid on the distributed income. The system was generally consistent with vertical equity, provided equivalent treatment for debt and equity and for different forms of business organization, did not discriminate against nonresident investors and produced capital import neutrality at both the company and shareholder level. The costs of the system were largely borne as administrative costs of government. This paper argues that simplification benefits could be produced if an optional system of corporate-shareholder taxation based on the 1915 model were introduced for private companies with only resident shareholders. The paper explains how such a system could be constructed to produce equivalent results for these companies to those produced under the current system and examines whether adoption of the proposed system would involve a breach of Australia's double tax agreement obligations. It details the design features of the proposed optional system and discusses whether its adoption would facilitate further simplification for companies in areas such as the debt/equity and thin capitalisation rules. The paper reflects on the impact that Australia's international obligations have had on the complexity of domestic tax design. The concluding section argues that a new international consensus that allows countries greater flexibility in design of corporate-shareholder tax systems is desirable given the challenges posed by financial engineering and globalisation.

I INTRODUCTION

Film historian Kevin Brownlow titled his 1968 tribute to the silent film, *The Parade's Gone By*. The title came from an incident reported to Brownlow by Monte Brice a writer and director of silent comedies. While on the set of the 1957 biopic *The Buster Keaton Story* Brice at one point had the temerity to suggest that a particular scene wasn't being filmed the way it would have been in the 1920s. He was told: 'Look, why don't you go away? Times have changed. You're an old man. The parade's gone by.' Those of you who have had the dubious pleasure of viewing *The Buster Keaton Story* might agree with me that it could not have been any worse if its makers had paid more attention to Brice.

I relate the incident because it not only reflects my eight year old son's comments whenever I tell him how things used to be when I was a child, 'that was the past; this is the future', but also because it reminds me of the reactions that I receive (at best polite silence, at worst incredulity) when I say I am researching the history of corporate-shareholder taxation. In this context, my defence for looking at history is the same as Brice's would have been, the product we have now could not be made any worse by looking at how things used to be. An understanding of where we have come from and of how we got to where we are can assist in remembering otherwise long forgotten alternatives and in identifying the causes of the constraints on our current policy choices. Having said this, before looking at the past, I will

* BA, LLB, LLM (Hons) (Sydney) Cer H Ed (UNSW); Associate Professor, School of Business Law and Taxation, University of New South Wales.

try to explain why I think this exploration is particularly relevant to the current tax reform debate in Australia.

II THE CURRENT TAX REFORM DEBATE IN AUSTRALIA

In Australia we are currently engaged in yet another debate about tax reform. The Board of Taxation recently reported to the Treasurer identifying those provisions in the *Income Tax Assessment Act 1936* (Cth) ('ITAA36') and the *Income Tax Assessment Act 1997* (Cth) ('ITAA97') which are no longer operative and for that reason could be repealed.¹ As a result, the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* (Cth) has just been enacted. The Treasurer has established a Task Force on how the regulatory burden on business, including those burdens imposed by Taxation Provisions (hereafter called the 'Red Tape Project'), could be reduced.² The Task Force's report was released on 7 April 2006.³ The Australian Tax Research Foundation has held a conference in 2006 which has examined how Australia expresses the tax base in legislation.⁴ The Taxation Institute of Australia is researching ways in which simplification of tax policy can lead to reduced compliance costs with emphasis on the identification and repeal of redundant provisions.⁵ The first in an anticipated series of reports for the Taxation Institute of Australia ('TIA') on this issue was released on 22 June 2006.⁶ In contrast with previous attempts to simplify language without simplifying policy and flirtations, via Option Two and the Tax Value Method, with more radical policy changes, the focus of many of the current projects (at the technical level at least) is on simplification in the organisation, approach and structure of the legislation rather than its language or its fundamental policy underpinnings.

The literature on tax complexity distinguishes between legal and effective simplicity. The legal simplicity or complexity of a tax law is determined by the ease or difficulty with which it can be read and understood. Tran Nam suggests that legal simplicity/complexity depend on: (a) the comprehensibility of the language used to express the law; and (b) content of the law. Tran Nam regards the content of the law as encompassing such matters as: the tax base, discretions, uncertainties, exemptions, special concessions, allowable deductions, rebates and multiple tax rates.⁷ Effective simplicity measures the value of resources expended by society in raising a given amount of revenue. Raising a given amount of revenue involves ascertaining how the tax laws apply to a given set of circumstances.⁸ As this process potentially involves taxpayers, tax administrators, judicial officers, and legislators, to measure the effective simplicity or complexity of a tax system, regard must be had to the costs borne by each of these potential participants.⁹ As Tran Nam has noted, effective simplicity encompasses legal simplicity but is additionally affected by:

¹ Board of Taxation, Commonwealth, *Identification and Possible Repeal of the Inoperative Provisions of the 1936 and 1997 Income Tax Assessment Acts — A Report to the Treasurer* (2005); Peter Costello, 'Income Tax Act Reduced by around 30 per cent' (Treasurer's Press Release No 102, 24 November 2005).

² Commonwealth Treasury, 'Taskforce on Reducing the Regulatory Burden on Business' (Treasurer's Press Release No 87, 12 October 2005).

³ Taskforce on Reducing Regulatory Burdens on Business, Commonwealth, *Rethinking Regulation* (2006).

⁴ Email from Graeme Cooper, Conference Organiser, to C John Taylor, 21 November 2005.

⁵ Letter from Noel Rowland, Chief Executive Officer, TIA to C John Taylor, 18 August 2005.

⁶ C John Taylor, *Beyond 4100: A Report on Measures to Combat Rising Compliance Costs through Reducing Tax Law Complexity* (2006).

⁷ Bihn Tran-Nam, 'Tax Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment' (1999) *21 Sydney Law Review* 500, 506.

⁸ *Ibid* 507.

⁹ *Ibid* 507.

- 1 the number of taxpayers and tax administrators;
- 2 the size distribution of taxpayers;
- 3 the business cycle; and
- 4 the general level of tax avoidance and tax evasion in the economy and the government's commitment to combat these.¹⁰

Many of the current projects, particularly the proposal to repeal inoperative provisions, appear to aim to improve the legal simplicity of Australia's tax legislation by reducing its sheer bulk. Others, such as parts of the TIA's submission to the Red Tape Project, aim to reduce effective complexity through the use of *de minimis* rules.

This paper is intended to be a contribution to this debate and is written on the basis that in the current Australian context achievable tax reform will neither be directed at fundamental shifts in tax policy, nor will it be a redrafting exercise, rather it will be concerned with ways in which the organisation and structure of the legislation can be changed so as to reduce its legal and/or effective complexity.

The major thesis of the paper is that many of the complex features of Australia's current system of corporate-shareholder taxation are the products of the choice to not fully extend imputation benefits to nonresident shareholders and the constraints of the international tax environment. The result is a system of corporate-shareholder taxation that is more complex than it needs to be for those Australian companies which do not have nonresident shareholders. If those companies could be given the option of using a simpler form of corporate-shareholder taxation, it is likely that there would be improvements in the legal simplicity of the tax system for those companies and improvements in the overall effective simplicity of the system.

What then would be the features of a simpler system of corporate-shareholder taxation designed for companies which have no nonresident shareholders? In answering that question it made sense to me to look at the Australian approach to corporate-shareholder taxation before this discriminatory policy was in place and before the international tax system was so constrained. Hence Section II of this paper examines the Australian corporate-shareholder tax system in the period from 1915 to 1923 after which it was changed significantly as a result of efforts to harmonise the collection of Federal and State income taxes. Section III of this paper then outlines the current Australian system of corporate-shareholder taxation. Section IV examines the effect of international and revenue considerations on the transformation of the simple system of 1915-23 to the complex system that prevails in 2005. Section V of this paper examines some data on private companies in Australia in an effort to estimate the number of private companies that do not have nonresident shareholders. Section VI then identifies the major domestic and international tax policy objectives that appear to underpin the current Australian system. Section VII argues that for private companies with no nonresident shareholders the domestic tax policy objectives of the current dividend imputation system identified in Section VI could be achieved more simply by allowing those companies the option of using a dividend deduction system. Section VIII then examines whether giving such companies this option would infringe Australia's Double Taxation Agreements ('DTAs'). The paper concludes in Section IX by reflecting on the impact that Australia's international obligations, primarily through DTAs, has had on the complexity of domestic tax design. The concluding section argues that a new international consensus that allows countries greater flexibility in design of corporate-shareholder tax systems is in fact desirable given the challenges posed by financial engineering and globalisation.

¹⁰ Ibid 508.

III THE SIMPLE PAST: AUSTRALIAN FEDERAL CORPORATE-SHAREHOLDER TAXATION 1915 TO 1923

From its inception in 1915 until 1923 the federal income tax used a dividend deduction system of corporate-shareholder taxation. Amendments introduced in 1916 limited the deduction to distributions of ‘assessable income’ which did not include items such as foreign source income and capital gains.¹¹ Capital gains were not included in the corporate tax base¹² but dividends funded from domestic source capital profits were assessable to shareholders at marginal rates.¹³ Hence, capital gains and other domestic preferences were washed out on distribution. In relation to distributions of current year income there was no need for inter-corporate dividend relief measures as the effect of the deduction for dividends was that distributions of current year income were not subject to corporate tax.

At the time, Australia adopted a wholly territorial approach to income taxation with foreign source income not being subject to Australian tax.¹⁴ In contrast to the treatment of domestic preferences, the portion of a dividend that represented a redistribution of foreign source income was not taxable to a shareholder.¹⁵ The result was that the system produced capital import neutrality at both the resident company level and at the underlying shareholder level. Equivalent treatment was also given to investment in resident companies with income that had been subject to foreign tax and investment in foreign companies. In addition, foreign source income that was not taxed to a resident company could be passed through to nonresident shareholders free of Australian tax.

Retained income was taxed at the company level. In 1918 the dividend deduction system was supplemented by a form of imputation system in relation to distributions of previously taxed income. The Commissioner could permit companies to charge any income tax that they had paid pro-rata against shareholders.¹⁶ From 1918 a rebate was allowed to both resident and nonresident shareholders for dividends funded from previously taxed corporate income. The rebate was limited to the lesser of tax at the corporate rate and tax at the shareholder’s rate on income from property.¹⁷ The rebate was calculated by the Australian Taxation Office on the basis of the paying company’s income tax return. This procedure meant that rebates were never given in respect of income which had not been subject to corporate tax thus avoiding the problem of super-integration. The same rebate provisions applied to both corporate and non-corporate shareholders. In determining the tax rate applicable to the shareholder the shareholder’s assessable income was not grossed up for corporate tax paid or by the amount of the rebate. The failure to gross up and the limitation of the rebate meant that the total corporate and shareholder tax on distributions of previously taxed income did not reflect the

¹¹ *Income Tax Assessment Act 1915* (Cth) (‘ITAA15’) s 16(1). *Income Tax Assessment Act No 2 1916* (Cth) substituted a new s 16(1) which limited the deduction to distributions of ‘assessable income’ as opposed to ‘income’ and inserted a definition of ‘assessable income’.

¹² Income was not defined but it was clear from the second reading speech of the Attorney-General, W M Hughes that the intention was that capital gains should not form part of the income tax base in order to encourage productive investment: Commonwealth, *Parliamentary Debates*, House of Representatives, 18 August 1915, 5845.

¹³ *ITAA15* s 14(1)(b) included in the income of any person: ‘dividends, interest, profits, or bonus credited or paid to any member, shareholder, or debenture-holder of a company which derives income from a source in Australia or of a company which is a shareholder in a company which derives income from a source in Australia’.

¹⁴ *ITAA15* s 10(1) levied tax, irrespective of residency considerations on taxable income from all sources in Australia.

¹⁵ *ITAA15* s 14(1)(b) second proviso, inserted by *Income Tax Assessment Act (No 2) 1915* (Cth).

¹⁶ *ITAA15* s 16(1) repealed by *Income Tax Assessment Act (No 2) 1916* (Cth). The same provision was re-enacted at s 16(1B) by *Income Tax Assessment Act (No 2) 1916* (Cth).

¹⁷ Section 16(2A) inserted by *Income Tax Assessment Act 1918* (Cth).

shareholder's marginal rate. The limitation on the rebate meant that, for shareholders on marginal rates below the corporate rate, in effect, a dividend exemption system applied in relation to distributions of income that had been subject to Australian corporate tax.

A defect in the system throughout the period was the significant disparity between the corporate rate and the top marginal rate. For the year ending 30th June 1916 the corporate rate was 7.5 per cent while the top marginal rate on income from property was 25 per cent.¹⁸ By the end of the period in which the dividend deduction system operated, the year ending 30 June 1923, after taking into account the effect of provisions imposing additional tax, the top marginal rate on income from property was 38.375 per cent.¹⁹ The rate of tax imposed on undistributed profits of a company was 12.08 per cent.²⁰ Because of the disparity of rates between the top marginal rate and the corporate rate, up to 1922 what was, in effect, a system of shareholder allocation by the Commissioner operated when a company had not made a sufficient distribution of taxable income in the year.²¹ In addition, the company remained liable for tax on its retained profits. The 1922 consolidation, *Income Tax Assessment Act 1922* (Cth), imposed additional tax on the company, equal to the excess of the tax that would have been payable by shareholders had there been a sufficient distribution over the tax paid by the undistributed income.²²

Between 1915 and 1922, partnerships²³ and trustees²⁴ were taxed at the entity level. Partners were also assessed on their individual interest in partnership income²⁵ and beneficial interests' income derived under a trust formed part of a beneficiary's income.²⁶ When income was distributed partnerships and trustees were allowed a proportionate rebate of the tax paid at the entity level.²⁷ The result was substantially equivalent to the treatment of companies with the exception that distributions of capital profits were not taxed at the partner or beneficiary level. The system for taxing partnerships and trusts was changed in the 1922 consolidation. Under the 1922 provisions, partnership income was only taxed at the partner level, *sui juris* beneficiaries were taxed on trust income to which they were presently entitled and the trustee was taxed on trust income to which no beneficiary was presently entitled or where a beneficiary was under a legal disability.²⁸ Until 1923 returns on debt interests in companies were given substantially equivalent treatment to that given to dividends.²⁹

A company was required to pay income tax on distributions to nonresidents or, at its discretion, withhold tax from them. A shareholder included the dividend in assessable income

¹⁸ *Income Tax Act (No 1) 1915* (Cth) sch 2 (rate on income from property), sch 3 (rate of tax on income of a company).

¹⁹ *Income Tax Act 1922* (Cth) s 5 imposed additional tax and sch 2 set the rate of tax on income from property.

²⁰ *Income Tax Act 1922* (Cth) sch 4.

²¹ *ITAA15* s 16(2).

²² *Income Tax Assessment Act 1922* (Cth) s 21.

²³ *ITAA15* s 25(1).

²⁴ *ITAA15* s 26(1).

²⁵ *ITAA15* s 25(2).

²⁶ *ITAA15* s 14(c).

²⁷ *ITAA15* s 27(1)-(2A).

²⁸ *Income Tax Assessment Act 1922* (Cth) s 29 imposed tax only at the partner level, while s 30 taxed *sui juris* beneficiaries on income to which they were presently entitled, and taxed the trustee on income to which either no beneficiary was presently entitled or where the presently entitled beneficiary was under a legal disability. These key features of the Australian tax treatment of partnerships and trusts have changed little since 1922.

²⁹ Up to 1923 the provisions relating to dividend deductibility and assessability also applied to distributions to debenture holders. After 1923 the deductibility provisions no longer applied to dividends but continued to apply to interest payments. The provisions relating to payments to nonresidents continued to apply to interest payments after 1923. See the amendments to s 20 of the *ITAA 1922* (Cth) by s 6 of the *Income Tax Assessment Act 1923* (Cth).

but, in determining tax payable, deducted the tax paid by the company.³⁰ The end result of the system was that equivalent treatment was given to resident and nonresident shareholders in respect of distributions of both current year income and taxed income of prior years. Although the treatment of nonresident shareholders was completely non-discriminatory the actual collection of tax from nonresident shareholders was clearly problematic.³¹

The treatment of nonresident shareholders was unaffected by DTA obligations for the simple reason that Australia had not entered into any DTAs by 1923. From 1921 until 1947, under the Dominion Income Tax Relief scheme, Australia provided double tax relief to United Kingdom ('UK') shareholders receiving dividends from Australian companies. Relief was granted by Australia where the tax payable by the shareholder, after relief had been given by the UK government, was greater than the highest rate of Australian and UK tax applicable to the shareholder.³² Because this system was not based on classifying income into different categories in limiting the source country's right to tax, Australia could attempt to tax nonresident shareholders on a net basis at normal statutory rates. Indeed, an impressive feature of the UK's Dominion Income Tax Relief system was the degree of diversity in systems of corporate-shareholder taxation that it permitted throughout the British Empire.

The majority report of the 1921-22 Warren Kerr Commission recommended the retention of the dividend deduction system at the Commonwealth level. After noting the inequities in the treatment of distributions of taxed income, the majority recommended that either the tax previously paid be refunded to the company or that a gross up and fully refundable credit mechanism operate at the shareholder level.³³ Refunding tax paid by the company would have excised the dividend imputation elements from the system and would have represented the treatment of distributions of taxed income which, as argued below, is to be preferred in dividend deduction systems.

In 1923, notwithstanding the recommendations of the Warren Kerr Commission, the Commonwealth, by repealing the dividend deduction provisions, converted its system to a dividend imputation system. The demise of the Commonwealth's dividend deduction system was not due to perceived technical problems in its operation but rather was a consequence of a 1923 Commonwealth-State agreement under which the Commonwealth took responsibility for the collection of state taxes. The Australian States at the time operated either classical or dividend exemption systems. The conversion of the Commonwealth system to a dividend imputation system brought it closer to the States' systems in that it now taxed both the distributed and undistributed profits of companies and hence facilitated the common collection of Commonwealth and State corporate taxes.

³⁰ The obligation to pay tax on assessable income distributed to nonresident shareholders and the credit for the tax paid by the company were inserted by the *Income Tax Assessment Act (No 2) 1916* (Cth). The option to withhold tax at source and to pay tax or withhold tax on interest paid to nonresidents and on distributions in relation to bearer debentures and share stock were inserted by the *Income Tax Assessment Act 1918* (Cth).

³¹ Given that the corporate rate, and from 1918 onwards the rate payable by companies on distributions to nonresidents, was considerably lower than the top marginal rate there was clearly a risk that nonresidents with Australian source income that placed them in the top marginal rate would not file returns. By 1945, when nonresidents were taxed on an assessment and prior year provisional tax basis, the Australian Commissioner of Taxation admitted in correspondence that it was not practical to enforce the Australian rules on taxation of nonresidents. Letter from I S Jackson (Australian Commissioner of Taxation) to Sir C Gregg (Chairman, UK Board of Inland Revenue) 25 September 1945, UK National Archives, Item Details DO 35/1157 File 0503/41.

³² Pursuant to an agreement with Great Britain in 1921, the *ITAA15* was amended to provide relief from international juridical double taxation. The relevant provision was s 12A inserted by the *Income Tax Assessment Act 1921* (Cth). Section 12A interacted with s 27 of the *Finance Act 1920* (UK) which introduced the Dominion Income Tax Relief system. The overall aim of the Dominion Income Tax Relief system was that the total tax on cross border income should not exceed tax at the higher of the two countries rates.

³³ Commonwealth, Royal Commission on Taxation, *Report of the Royal Commission on Taxation: Second Report* (1922), [295], Recommendation 1 and see discussion at [290] and [292].

In summary, the system of corporate-shareholder taxation adopted in the *ITAA15* was both elegant and simple. Dividends paid out of current year income were deductible to the company and fully assessable to shareholders. Where dividends were paid out of taxed retained income shareholders received a credit (but not a gross up) for corporate tax paid on the distributed income. The system, was generally consistent with vertical equity considerations; provided equivalent treatment for debt and equity and for different forms of business organisation; did not discriminate against nonresident investors; and (due to the territorial basis of the Australian system and specific pass through provisions) produced capital import neutrality at both the company and shareholder level. Moreover the costs of the complexity in the system were largely borne as administrative costs of government. The most complex features of the system concerned the treatment of distributions of income that had been subject to Australian corporate tax. If the recommendation of the Warren Kerr Commission, that corporate tax be refunded to companies making such distributions, had been enacted, the potentially complex dividend imputation features of the system could have been excised and greater vertical equity would have been achieved. The absence of an effective withholding tax system meant that, although the treatment of nonresident shareholders was completely non-discriminatory and completely unaffected by DTA obligations, the actual collection of appropriate levels of Australian tax on dividends paid to nonresidents proved to be problematic.

IV THE HARROWING COMPLEXITY OF THE PRESENT: AUSTRALIAN CORPORATE-SHAREHOLDER TAXATION IN 2005-06

If we now jump forward over 80 years to the present we find Australian corporate-shareholder system which is highly complex by any measure. Since 1987 Australia has had a shareholder credit or variable credit type of dividend imputation system. Since the so-called Simplified Imputation System was introduced in 2002, it has been largely modelled on the New Zealand system and, arguably, has in fact become more complex.

The main features of the Australian system of corporate-shareholder taxation are well known and are set out only briefly here. A resident company and certain New Zealand ('NZ') companies are obliged (or, in the case of NZ companies, permitted) to maintain franking accounts which track Australian corporate tax paid or payable (in the form of franking deficit tax) by the company or the franked amount of dividends received from another resident company. Payments of foreign corporate tax do not generate franking credits. A company may attach franking credits to dividends that it pays. The maximum franking credit that a company can attach to a dividend equals the amount of the dividend multiplied by $c/1-c$ where c is the currently applicable corporate tax rate. The first dividend paid by a company in a franking period (one year for private companies and six months for public companies) establishes the company's benchmark franking per centage for that period. In an effort to prevent dividend streaming within a franking period the system, subject to some exceptions for public companies, imposes a penalty tax (overfranking tax) if a company attaches more franking credits to a dividend than is consistent with its benchmark per centage. Where a company attaches more franking credits to its dividends than it has or generates in its franking account before the end of franking year, it may produce a franking deficit at the latter time. Franking deficit tax is offset against the company's future mainstream company tax instalments and can be classified as a form of equalisation or compensatory tax. Where the franking deficit exceeds 10 per cent of the company's total franking credits for the year the offset against mainstream company tax is reduced by 30 per cent. Attaching fewer franking credits to a dividend than is consistent with the company's benchmark per centage produces a debit in the company's franking account but does not pass a corresponding franking credit on to shareholders. Hence the effect is simply that underfranking produces a

loss of franking credits for the company. Specific anti-streaming rules and a requirement that companies report excessive variations in their benchmark per centage are aimed at preventing dividend streaming between periods. The system also contains a general anti-avoidance rule directed at dividend streaming and rules aimed at counteracting trading in franking credits.³⁴

Receipt of a franked dividend produces a credit in the recipient company's franking account equal to the franking credits attached to the dividend. The recipient company also is allowed a gross up and credit for any franking credit attached to the dividend. While this means that a dividend that is franked to 100 per cent will be tax free to the recipient company it also means that a recipient company will have a tax liability on any dividend received that is franked to less than 100 per cent. Any tax paid by the recipient company on dividends franked to less than 100 per cent will in turn generate credits in the recipient company's franking account. This is in contrast to the treatment of inter-corporate dividends prior to 1999 where the rebate under s 46 of the *ITAA36* meant that dividends paid by a resident listed company were effectively tax free to a resident recipient company whether or not they were sourced in profits that had borne Australian corporate tax.³⁵ Although excess franking credits are generally refundable under the Simplified Imputation System this is not the case where the recipient of the dividend is a company. Excess credits are divided by the corporate rate and are carried forward by the company as tax losses.

Franking credits attached to dividends paid to resident shareholders are included in the assessable income of the shareholder. Tax is assessed on the shareholder's grossed up income and the shareholder is allowed a tax offset equal to the amount of the attached franking credit. Excess credits are refundable to resident shareholders other than companies and some tax exempts. Excess credits on dividends received by resident companies are converted into tax losses in the manner described in the previous paragraph. The unfranked part of a dividend paid to a nonresident is subject to withholding tax. Nonresidents are not entitled to a franking gross up and credit but the franked part of a dividend paid by a resident company (and by certain NZ companies) to a nonresident is not subject to withholding tax. Certain redistributions of foreign source income to nonresident shareholders are also not subject to withholding tax. Dividends paid to nonresidents that are subject to withholding tax or would be but for certain specified exemptions (including the two previously mentioned) are not subject to tax on an assessment basis.

For resident shareholders the effect of the system is that the overall level of Australian tax on distributions of income that has borne Australian corporate tax represents taxation at the shareholder's marginal rate. The treatment of unfranked dividends and the operation of franking deficit tax mean that corporate tax preferences are washed out on distribution. As taxed foreign source income will either be within the 'exemptions' under ss 23AH or 23AJ of the *ITAA36* or subject to a foreign tax credit it will not, at least to the extent that it has borne foreign tax, be subject to Australian corporate tax. Hence, to that extent, it will not generate Australian franking credits and the exemption or credit treatment given to foreign source income at the Australian corporate level will be washed out on distribution. The payment of foreign tax will, in effect, be treated as a pre-tax expense.

³⁴ For a discussion of anti-dividend streaming and anti-franking credit trading rules see F Gilders, J Taylor, G Richardson, and M Walpole, *Understanding Taxation Law: An Interactive Approach* (2nd ed, 2004), 676-91.

³⁵ Limitations on the inter-corporate rebate were imposed in 1999 prior to the introduction of the Simplified Imputation System by restricting the rebate on dividends paid by listed companies to the franked portion of the dividend. This had been the position for some years in relation to dividends paid by unlisted companies. When the 1999 restrictions were introduced, resident companies receiving non-portfolio dividends that were not fully franked from other (non-group) resident companies received a deduction under s 46FA of the *ITAA36* to the extent that they redistributed those dividends to nonresident companies.

The complexities of the dividend imputation system are exacerbated by the fact that it intertwines with a whole host of other complex rules that affect corporate-shareholder taxation. Those rules include: the debt and equity rules; the rules relating to tainting and untainting the share capital account; the thin capitalisation rules; the CGT system; the consolidation rules; the dividend stripping rules; the rules governing the cost of bonus issues; the buy back rules; various deemed dividend rules; the anti capital benefit streaming rules; the direct and indirect value shifting rules; the CFC rules; the FIF rules; the trans-Tasman triangular taxation rules; the exempting company rules; the 'exemptions' for foreign branch profits and non portfolio dividends; the foreign tax credit rules; and the personal services income alienation rules. Merely listing potentially relevant rules is itself a complex operation. Explaining their interactions and getting a real sense of the overall operation of the corporate-shareholder taxation system can be truly mind-boggling.

Survey evidence supports the assertion that Australian corporate taxation is complex. Company income tax has been found to have considerably higher compliance costs than personal income tax both in absolute terms and as a per centage of revenue collected.³⁶ For companies, internal costs represented 48 per cent of compliance costs with external costs for professional fees representing 52 per cent of compliance costs.³⁷ Computational costs represented 76.2 per cent of all corporate compliance costs with planning costs representing 23.8 per cent of corporate compliance costs. Planning costs represented a higher per centage of the total compliance costs for smaller companies while computational costs represented a higher per centage of the total compliance costs of the largest companies.³⁸ Corporate compliance costs were found to be heavily regressive.³⁹

In summary, Australia currently uses a dividend imputation credit type system which since 2002 has been modelled on the NZ system. While the current system produces vertical equity, by permitting either full pass through or deferred recognition of tax preferences it favours partnerships and trusts over the corporate form. It also discriminates against nonresident investors by not fully extending imputation benefits to them. Moreover, while producing capital import neutrality at the corporate level (where either s 23AH or s 23AJ of the *ITAA36* is applicable), it only produces national neutrality at the underlying resident shareholder level as payments of foreign tax are merely treated as pre-tax expenses for purposes of the dividend imputation system. The system is also much more complex than its 1915-23 progenitor and most of the cost of this complexity is now borne at the corporate level as compliance costs.

V THE JOURNEY FROM SIMPLICITY TO COMPLEXITY: THE EFFECTS OF INTERNATIONAL AND REVENUE CONSIDERATIONS ON THE DESIGN OF THE AUSTRALIAN DIVIDEND IMPUTATION SYSTEM

Many of the most complex features of the current Australian dividend imputation system can be regarded as being products of the national and international tax environment in which Australia reintroduced a dividend imputation system in 1987.

The dividend imputation system introduced in 1923 lasted until 1940 when it was converted to a classical system to assist in generating greater revenue to fund Australia's participation in World War II.

³⁶ See J Pope, R Fayle and D L Chen, *The Compliance Costs of Companies' Income Taxation in Australia* (1994), 69; J Pope, R Fayle, and D L Chen, *The Compliance Costs of Public Companies' Income Taxation in Australia 1986/87* (1991), 88; and J Pope, R Fayle, and M Duncanson, *The Compliance Costs of Personal Income Taxation in Australia 1986/87* (1990), 48.

³⁷ Pope, Fayle and Chen, above n 36, 69.

³⁸ *Ibid* 67.

³⁹ *Ibid* 69.

By the time Australia re-introduced a dividend imputation system in 1987, the national and international tax world had radically changed. The 1987 dividend imputation system was replacing a classical system that had been in place for over forty years at a time when fiscal responsibility, revenue neutrality and efficiency considerations were paramount. Governments of countries recovering from the recessions of the late 1980s and early 1990s were preoccupied with deficit reduction. By this time the practice of existing imputation countries was to not unilaterally extend imputation credits to nonresidents; to not grant credit for payments of foreign tax; and to wash out corporate tax preferences (including tax preferred treatment of foreign source corporate income) on distribution to resident shareholders.⁴⁰

Four key international developments in the intervening period also arguably had a significant effect on Australia's choice of a dividend imputation system. These were: (a) the gradual development between the 1920s and the 1960s of an international framework for the interaction of tax rules between developed countries based on a network of bi-lateral DTAs; (b) the development of Australia's DTA network; (c) the rejection of effective reciprocity of withholding taxes in the *Commentary to the OECD Model Double Taxation Convention*; and (d) the inclusion of the non-discrimination article in the *OECD Model Double Taxation Convention*.

A *The Development of an International Framework for the Interaction of Tax Rules*

The current international framework for the interaction of tax rules is a network of bilateral treaties which are either based on or heavily influenced by the *OECD Model Double Taxation Convention*. The *OECD Model Double Taxation Convention* as we now know it had its origins in work by committees of the International Chamber of Commerce and of the League of Nations in the 1920s and in the treaty practices of member states of the League of Nations. The process of development was lengthy, interrupted as it was by the involvement of the major capital exporting countries in World War II. From the beginning, the process reflected a tension between the interests of capital exporting and capital importing countries. By the mid 1940s a compromise was reached between developed countries. Source countries restricted their rights to tax investment income, by either not taxing it all or by imposing limitations on withholding taxes, thus assigning the major right to tax investment income to residence countries which were obliged to relieve international juridical double taxation. Conversely, source countries were given the right to tax business income attributable to permanent establishments at full statutory rates with the effect that the residence country only had a right to tax business income to the extent that its rate exceeded the source country rate. Fundamental to this consensus was a classification of taxes into origin (or source) taxes and residence taxes first developed in draft I-b of the 1928 draft of the Committee of Technical Experts of the Fiscal Committee of the League of Nations. Origin taxes were those imposed on non-residents on income from sources within the country of origin. Residence taxes were those imposed on residents on their worldwide income. Previous and other contemporary drafts by the Committee of Technical Experts had distinguished between personal and impersonal taxes and had consigned the right to levy personal taxes to the country of residence and the right to levy impersonal taxes to the country of origin.

In the context of this paper the significant point to stress is the influence of countries that used classical tax systems in the development of the eventual compromise. Germany switched to a classical system of corporate-shareholder taxation in 1925. German tax treaty

⁴⁰ See K Messere, 'Half a Century of Changes in Taxation' (1999) 53 *Bulletin for International Fiscal Documentation* 340, 351 and OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (1991), 57, 164.

practice, reflecting its classical and earlier schedular system was extremely influential in continental Europe in the 1920s and was reflected in draft 1c of the League of Nations 1928 *Draft Model Taxation Convention*.⁴¹ The involvement of another classical corporate tax system country, the United States ('US'), from 1927 onwards, was also extremely significant. A distinction between personal and impersonal taxes was problematic for countries like the UK and the UK (and for that matter Australia) which had global rather than schedular systems (the UK system not being a true schedular system in the sense that many continental European systems were) and hence arguably had no impersonal taxes. The development of the origin taxes – residence taxes distinction allowed countries using global systems to tax nonresidents.⁴² The distinction, and the assignment of investment income to residence countries and business income to source countries, also dovetailed neatly with existing domestic rules in the US particularly with the foreign tax credit⁴³ and with the use of a classical system of corporate-shareholder taxation. The distinction also proved to be compatible with European schedular systems.

Taxation of foreign owned subsidiaries as residents, ceding the primary right to tax business profits to the source country where a permanent establishment is present, taxation of dividend income at source, reciprocal reductions in withholding taxes and no or limited relief to portfolio shareholders from economic double taxation all make sense in the context of schedular systems and classical corporate tax systems. Common to both systems is a view of the corporate income tax as a tax on a legal person and of the tax on dividends as a tax on distinct legal persons. In schedular systems the conceptual basis for having distinct and separate company and shareholder taxation is reinforced by the fact that one is seen as a personal tax while the other is seen as an impersonal tax. In these systems differential corporate and shareholder taxation is justified as the income subject to tax at each level is seen as arising from different sources. The framework as developed was to prove to be less appropriate for integrated systems of corporate-shareholder taxation.

B *Development of Australia's Bilateral Double Taxation Convention Network*

Australia's first bilateral DTA was concluded with the UK in 1946 and entered into force in 1947.⁴⁴ It was followed by DTAs with the US in 1953,⁴⁵ Canada in 1957 (entered into force 1958)⁴⁶ and New Zealand in 1960.⁴⁷ All of these conventions reflected the international consensus that had developed by the mid to late 1940s. By 1987 Australia had a well

⁴¹ See the discussion in P A Harris, *Corporate/Shareholder Income Taxation And Allocating Taxing Rights Between Countries* (1996), 303, 297, 291-3.

⁴² The US only became involved in the Committee of Technical Experts of the Fiscal Committee of the League of Nations in 1927. For an account of the influence of the US representative, T C Adams, on the eventual consensus and on draft 1b of the 1928 drafts see M J Graetz and M M O'Hare, 'The Original Intent Of US International Taxation' (1997) 44 *Duke Law Journal* 1021, 1081-90.

⁴³ Significantly, none of the League of Nations draft model conventions nor any of the versions of the OECD model convention have, in the text of the model itself, said anything about the prevention of the economic double taxation of portfolio investors. The US *Internal Revenue Code* at the time only allowed an indirect foreign tax credit to parent companies owning at least 50 per cent of the relevant subsidiary company.

⁴⁴ *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 29 October 1946, Australia–United Kingdom, [1947] ATS 18 (entered into force 3 June 1947).

⁴⁵ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 14 May 1953, Australia–United States, [1953] ATS 4 (entered into force 14 December 1953).

⁴⁶ *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 1 October 1957, Australia–Canada, [1958] ATS 12 (entered into force 21 May 1958).

⁴⁷ *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 12 May 1960, Australia–New Zealand, [1960] ATS 6 (entered into force 23 June 1960).

developed network of DTAs (excluding Airline Profits Agreements) with 23 countries.⁴⁸ In general these DTAs followed the *OECD Model* subject to Australia's reservations in relation to some articles. In some instances, in treaties with then less developed countries, Australia's DTAs were influenced by the *UN Model* (for example in relation to the definition of 'permanent establishment'). By 1987, Australia's DTAs almost universally imposed a reciprocal limitation of 15 per cent on the dividend withholding tax that the contracting states could levy. It is important to note that, as will be discussed in more detail below, by 1987 only Australia's DTA with the US contained a non-discrimination article.⁴⁹ At this time Australia's long-standing position had been not to agree to the non-discrimination article.⁵⁰ Nonetheless, subsequent protocols to several of Australia's other DTAs obliged it to agree to a non-discrimination article with the state in question if Australia subsequently entered into a convention with a third state which contained a non-discrimination article.

C *The Rejection of 'Effective Reciprocity'*

From the mid 1960s onwards a trend towards integrated systems of corporate-shareholder taxation developed within the OECD. Classical systems had become popular within the OECD during the Great Depression and World War II as part of an effort to increase revenues. For many countries the adoption of integrated systems represented a return to systems akin to those they had used earlier in their tax history. Nonetheless, the international framework for the interaction of tax rules eventually proved to be unwilling to adapt to the shift to integrated systems.

Some countries, most notably Germany but also others such as Norway, introduced split rate or dividend deduction systems that provided relief at the corporate level. Internationally the use of these systems was problematic due to the reciprocal reduction in withholding taxes which had become standard in double taxation conventions based on the *OECD Model*. Some earlier post World War II double taxation conventions had tried to take the overall level of corporate-shareholder taxation in the respective contracting states into account in determining the extent and nature of the treaty reductions in corporate-shareholder taxation. For example, under the 1945 *United Kingdom – United States Double Taxation Convention*,⁵¹ the US reduced its withholding tax on dividends from 30 per cent to 15 per cent while the UK agreed not to levy surtax on dividends paid to nonresident shareholders.⁵² As the standard tax rate payable by UK companies was 50 per cent plus a 5 per cent national defence contribution, while the US corporate rate was 40 per cent the treaty reductions meant that the total corporate and shareholder source country tax on dividend income was 55 per cent.⁵³ Consistently with this approach the DTA provided for an indirect foreign tax credit

⁴⁸ Commonwealth Treasury, *Australian Tax Treaty Table* (2006) <http://www.treasury.gov.au/documents/625/XLS/Australian_Tax_treaty_tableSept2006.xls> at 28 September 2006.

⁴⁹ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 6 August 1982, Australia–United States, [1983] ATS 16, art 23 (entered into force 31 October 1983).

⁵⁰ See the summary of the Australian approach to DTA negotiations by L Bury, Treasurer, Cabinet Submission No 65, 5 January 1970, [8]. In this connection it is notable that the non-discrimination article under the *Australia – United States Double Taxation Convention* was not given the force of law. See *International Tax Agreements Act 1953* (Cth) s 6.

⁵¹ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 16 April 1945, United Kingdom–United States, 12 Bevans 671 (entered into force 25 July 1946).

⁵² *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 16 April 1945, United Kingdom–United States, 12 Bevans 671, arts VI(1)-(2) (entered into force 25 July 1946). The US withholding tax was reduced to 5 per cent in the case of dividends paid to parent companies owning at least 95 per cent of the subsidiary company.

⁵³ See the discussion in F E Koch, *The Double Tax Conventions – Volume 1: Taxation of Income* (1947), 73-4.

irrespective of the level of ownership of the shareholder.⁵⁴ In the 1960s, Germany tried to persuade its major treaty partners, especially the US, to permit it to levy a non-reciprocal and higher withholding tax on dividends. The German argument was that such treatment would represent ‘effective reciprocity’ as the split rate system meant that Germany was levying a lesser tax on distributed corporate profits. Germany’s lack of success in its negotiations with the US would not have provided Australia with any encouragement at all if it had been disposed to pursue either a split rate or a dividend deduction system.⁵⁵

The attitude of the *Commentary on the OECD Model* to ‘effective reciprocity’ of withholding taxes reversed itself during this period. Under effective reciprocity a comparison is made, not just between the withholding rates of the parties to a bi-lateral convention, but between the combined levels of corporate and shareholder taxes on corporate distributions in each jurisdiction. The *Commentary on the 1963 OECD Draft Convention* appeared to have accepted effective reciprocity. The statements supporting effective reciprocity were removed from the 1977 edition of the Commentary. The attitude to effective reciprocity hardened in the 1992 Commentary which regarded ‘balancing’ withholding taxes that were not creditable for foreign tax credit purposes as discrimination by the source country against foreign investors and as discriminating against foreign investment as compared to domestic investment from the residence country’s viewpoint.⁵⁶

D The Development of the ‘Non-Discrimination’ Article

Vogel notes that non-discrimination rules specifically in regard to tax law had been introduced as early as 1892 in bilateral treaties of friendship, commerce and navigation.⁵⁷ The 1921 and 1923 resolutions of the International Chamber of Commerce had affirmed non-discrimination between foreigners and residents.⁵⁸ Nonetheless non-discrimination articles only gradually found their way into model DTAs. A non-discrimination article was not included in the 1927 *Draft Bilateral Convention for the Prevention of Double Taxation* prepared by the League of Nations Committee of Technical Experts on Double Taxation and Tax Evasion.⁵⁹ The *Mexico Draft Double Taxation Convention* produced by the League of Nations Committee on Fiscal Affairs did contain a non-discrimination article requiring that taxpayers with fiscal domicile in one contracting state should not be subject in the other contracting state to higher or other taxes than a taxpayer having fiscal domicile or nationality in the other state.⁶⁰ Similarly, the early DTAs entered into by the US did not contain

⁵⁴ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 16 April 1945, United Kingdom–United States, 12 Bevans 671 (entered into force 25 July 1946).

⁵⁵ See the discussion of the negotiations between Germany and the US in the 1960s in D R Tillinghast, ‘The Revision of the Income Tax Convention between the United States and the Federal Republic of Germany’ (1966) 21 *Tax Law Review* 399, 404-6. For a briefer summary which places these negotiations in a more general policy context see H J Ault, ‘Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices’ (1992) 47 *Tax Law Review* 565, 583-4. Ault notes that Germany had some success in achieving non reciprocal withholding tax rates in negotiations with treaty partners other than the US.

⁵⁶ For a discussion of the initial acceptance and ultimate rejection of ‘effective reciprocity’ in the commentary on the *OECD Model* see P A Harris, ‘Origins of the 1963 OECD Model Series: Working Party Twelve and Article 10, Part I’ [1999/2000] 1 *Australian Tax Forum* 3, 22-3.

⁵⁷ K Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, 1997), 1280.

⁵⁸ See the discussion in Graetz and O’Hare, above n 42, 1068-70.

⁵⁹ League of Nations, *Double Taxation And Tax Evasion: Report Presented By The Committee of Technical Experts on Double Taxation and Tax Evasion* (1927), League of Nations Doc C.216.M.85.1927.II.

⁶⁰ League of Nations, *London and Mexico Double Tax Conventions: Commentary and Text* (1946), League of Nations Doc II.A.7, Article XIV of the Mexico Draft, 4388.

comprehensive non-discrimination articles. Neither the US – France Conventions of 1932⁶¹ and 1939⁶² nor the US – Canada Convention of 1942⁶³ contained non-discrimination articles. The US – Sweden Convention of 1939⁶⁴ did contain an article to the effect that citizens of each state residing within the other contracting state would not be subjected in the latter state to other or higher taxes than were imposed upon citizens of the latter state. The US – UK Convention of 1945⁶⁵ contained a similar article directed at discrimination against nationals. Contemporary commentators questioned whether corporations could be classified as nationals of either state under the article. No equivalent to the current art 24(5) of the *OECD Model Double Taxation Convention* was included in any of the early US Conventions.⁶⁶ None of Australia's DTAs prior to the publication of the 1963 *Draft OECD Model* included a non-discrimination article. A non-discrimination article was included in the 1963 *OECD Draft Model Double Taxation Convention*. In the context of this paper the most important provision in the non-discrimination article was art 24(5) which prohibited other or more burdensome taxation of enterprises controlled by residents of the other contracting state as compared with similar enterprises of the first contracting state. Australia reserved its position on art 24. Nonetheless an overwhelming majority of OECD members did not reserve their position on the non-discrimination article and its inclusion in DTAs became the international practice.

E *The Impact of these Developments on Australia's Choice of an Imputation System*

As Warren has noted, the 1920s division of the income tax base failed to evolve in response to corporate tax integration.⁶⁷ A relatively early consequence of that failure was the demise of systems of corporate-shareholder integration providing relief at the corporate level and the growing popularity by the mid 1980s of systems providing relief at the shareholder level. As will be discussed in more detail below, systems providing relief at the shareholder level were able to discriminate against nonresident shareholders and to wash out corporate tax preferences for foreign source income on distribution. These features meant that these types of integration systems operated like classical systems internationally.

In combination the non-discrimination article and the rejection of effective reciprocity meant that the use of a split rate or dividend deduction system came to be seen internationally as generating insufficient revenue from companies controlled by nonresidents when compared with an imputation system where unilateral credit was not required to be given to nonresidents. The rejection of effective reciprocity meant that a country using either a split rate or a dividend deduction system could not use higher withholding taxes on dividends to compensate for corporate tax revenue lost⁶⁸ when deductions were obtained for dividends distributed to nonresidents.

⁶¹ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 27 April 1932, France–United States, 7 Bevens 977 (entered into force 1 January 1936).

⁶² *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 25 July 1939, France–United States, 7 Bevens 1046 (entered into force 1 January 1945).

⁶³ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 4 March 1942, Canada–United States, 6 Bevens 244 (entered into force 15 June 1942).

⁶⁴ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 23 March 1939, Sweden–United States, 11 Bevens 809 (entered into force 14 November 1939).

⁶⁵ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 16 April 1945, United Kingdom–United States, 12 Bevens 671 (entered into force 25 July 1946).

⁶⁶ See M B Carroll, 'Double Taxation Conventions Concluded by the United States Since 1939' V (1947) *Cahiers de Droit Fiscal International* 25, 61-3.

⁶⁷ See A C Warren, 'Income Tax Discrimination against International Commerce' (2001) 54 *Tax Law Review* 131 at 147.

⁶⁸ See the discussion in J F Avery Jones et al, 'The Non-discrimination Article in Tax Treaties, I and II' [1991] *British Tax Review* 359, especially 443-4.

If a country using either a split rate or a dividend deduction system tried to protect its corporate tax base by denying a company a deduction for dividends paid to nonresidents then technically it was in breach of the non-discrimination article in the *OECD Model*. By contrast, the better view was that denial of an imputation gross up and credit to a nonresident shareholder technically did not breach the non-discrimination article.⁶⁹

The influence of these international developments was evident in the proposal in the Australian Treasury Draft White Paper of 1985, *Reform of the Australian Tax System*, that a full or partial dividend imputation system for resident individual shareholders be introduced.⁷⁰ The ability to deny imputation credits to nonresident shareholders was explicitly stated to be an advantage of an imputation system⁷¹ while difficulties associated with taxing profits of local subsidiaries of foreign parents was regarded as the decisive consideration against a split rate system.⁷² Both considerations had previously been noted by the Asprey Committee in 1975.⁷³ Reflecting the mood of fiscal responsibility of the period these reforms were all required to be revenue neutral.⁷⁴

F *The Impact of Revenue Considerations on Australia's Choice of an Imputation System*

The imputation system eventually introduced in Australia in 1987 did depart in some respects from the then dominant model of imputation in the OECD. Initially Australia had intended to adopt an imputation system with a compensatory or equalisation tax modelled on the then current UK Advance Corporation Tax system. The variable credit type of imputation system ultimately introduced by Australia appeared to be heavily influenced by a model developed in the interim by Bengé and Robinson.⁷⁵ Under the system as initially implemented a company, within certain limits (such as the rule requiring all dividends paid on shares in the same class to be franked to the same amount) was able to choose the extent to which it franked a dividend. Adverse consequences could follow, however, for a company that did not attach franking credits to a dividend to the extent that, having regard to matters such as committed future dividends, credits were available in its franking account. In effect, the required franking amount rules operated as ordering rules which regarded taxed profits as being distributed first. Under the rules it was possible, and even usual, for companies to distribute their taxed profits as fully franked dividends and to retain their untaxed profits. Where a company chose to retain its untaxed profits the system enabled credit at the shareholder level to be restricted to distributions of profits that had borne corporate tax thus avoiding the problem of super-integration without imposing a compensatory tax. When a company distributed untaxed profits without attaching franking credits to the distribution, no gross up and credit was received by the shareholder. Where a company chose to attach franking credits to distributions of untaxed profits it could render itself liable for a compensatory or equalisation tax in the form of franking deficit tax. The principal reason for the choice of this form of dividend imputation system appears to have been unease in corporate Australia at the prospect of payments of Advance Corporation Tax adversely

⁶⁹ Ibid.

⁷⁰ Commonwealth Government, *Reform of the Australian Tax System: Draft White Paper* (1985), ch 17. A summary of the proposed options is at [17.33].

⁷¹ Ibid [17.23].

⁷² Ibid [17.19].

⁷³ On the lack of obligation to extend imputation credits to nonresidents, see Commonwealth Government, *Taxation Review Committee: Full Report* (1975), [16.65]-[16.71]. On difficulties associated with a split rate system, see [16.35].

⁷⁴ Commonwealth Government, above n 70, 2.

⁷⁵ M Bengé and T Robinson, *How To Integrate Company And Shareholder Taxation: Why Full Imputation Is The Best Answer* (1986).

affecting reported after tax profits of listed companies.⁷⁶ Similar concerns continued to be raised by corporate Australia when the Review of Business Taxation ('RBT') canvassed the possibility of using a deferred company tax as a solution to the problem of dividend streaming.⁷⁷

At the same time the complex franking account mechanism introduced in 1987 can be seen as being driven by revenue considerations aimed as it was at preventing the granting of imputation credits on distributions of untaxed income. The wash out of corporate tax preferences on distribution was not an inevitable consequence of that system but was a feature which carried over from the classical system, was consistent with the practice of other imputation countries, and assisted the achievement of the goal of overall revenue neutrality in reform package. A concern to minimise revenue costs was also evident in the non-refundability of imputation credits in the 1987-1999 system.

G The Legacy of the Choices Made by Australia in Designing its Imputation System

In combination these features produced biases in the system which led to the development of a complex set of rules directed against dividend streaming, franking credit trading and capital benefit streaming. The problem of dividend streaming was the price that Australia paid for adopting a variable credit type of imputation system and for deciding not to extend franking credits to nonresident shareholders. The so called Simplified Imputation System introduced in 2002 following recommendations of the RBT changed the whole basis of franking under the system to benchmark franking in an effort to curtail dividend streaming.

Arguably the recommendations of the RBT did little to remove biases in the system or to simplify it. The RBT rejected a general pass through of corporate tax preferences in companies because of revenue considerations.⁷⁸ This coupled with the decision to continue to not grant franking credits to nonresidents meant that the changes implemented in response to RBT recommendations, with the exception of the introduction of refundable franking credits, while simplifying the operation of the system in some respects and while making imputation planning more difficult, did not really address the underlying biases that caused complexity in the system. In fact the changes to the inter-corporate dividend rebate exacerbated the biases against investment by residents in resident companies with taxed foreign income.

VI CURRENT KEY DESIGN FEATURES IN AUSTRALIA'S DIVIDEND IMPUTATION SYSTEM AND THEIR POLICY UNDERPINNINGS

The Australian dividend imputation system is one of several alternative approaches to integrating a country's corporate and shareholder tax systems. The following may be regarded as the key design features of Australia's current dividend imputation system:

- 1 The overall rate of tax on taxed income passing through a resident company to a resident individual shareholder represents taxation of that income at the shareholder's marginal rate;
- 2 Where a distribution produces an excess credit for a resident shareholder the excess credit is fully refundable to shareholders other than corporates and some tax exempts;
- 3 Where a distribution produces an excess credit for a resident corporate shareholder the excess credit is converted into a tax loss for the shareholder;

⁷⁶ See the discussion in R J Vann, 'Overview Of Company Tax Reform' in R J Vann (ed), *Company Tax Reform* (1988) 3, 7.

⁷⁷ Commonwealth Treasury, RBT, *A Tax System Redesigned* (1999), 411.

⁷⁸ *Ibid*, 62.

- 4 Except in the case of dividends paid within a consolidated group (which are ignored for tax purposes) the same gross up and credit mechanism operates for dividends received by Australian resident companies as operates for dividend received by Australian resident individuals;
- 5 Tax preferred income (including tax preferred foreign source income) distributed by a resident company to a resident shareholder (individual or corporate) is taxed at the shareholder's marginal rate;
- 6 Tax credits given to resident shareholders are limited to the franked portion of the distribution which represents tax paid or payable by the resident company;
- 7 Except where a resident company attaches franking credits to a distribution in circumstances that ultimately trigger a liability for franking deficit tax, a compensatory tax is not levied on distributions of income that has not borne Australian corporate tax;
- 8 Resident companies (because of the benchmark franking rule) can retain untaxed income and distribute taxed income with franking credits attached;
- 9 Taxed income retained by resident companies is only taxed at the corporate rate until it is distributed but personal services income alienation provisions may mean that the income is taxed at the marginal rate of the person providing the personal services;
- 10 The streaming of franking credits away from shareholders who have little or no use for them is circumvented by the benchmark franking rule and by several specific rules proscribing dividend streaming;
- 11 Trading in franking credits by shareholders is circumvented by specific measures against franking credit trading; and
- 12 To the extent that a distribution by a resident company to a nonresident shareholder (individual or corporate) represents taxed income it is exempt from Australian withholding tax but no gross up or tax offset is given to the nonresident shareholders.

These key design features may be regarded as being consequences of a more limited number of Australian domestic and international tax policies relevant to corporate-shareholder taxation. Domestically, the broad policy objectives of the dividend imputation system can be stated as: (a) that the overall level of taxation of profits that pass through a resident company to a resident shareholder should represent taxation at the relevant shareholder's marginal rate; (b) as a consequence corporate tax preferences are washed out on distribution; and (c) that companies can attach credits to dividends in a manner that achieves these results without paying a compensatory tax.

Internationally the broad policy objectives of the imputation system can be stated as: (a) preventing credit from being given for payments of foreign tax; and (b) discriminatory treatment of nonresident shareholders in situations where reduced rates of withholding tax apply under a DTA. The former policy arguably produces a bias at the resident shareholder level against investment in resident companies with foreign source income that has been subject to foreign tax. This bias is mitigated by the ability of resident companies to fund franked dividends from taxed profits and to retain untaxed profits. In respect of the latter policy, as noted previously, the better view is that technically the discrimination does not amount to a breach of the non-discrimination article in Australia's DTAs.

The argument of this paper is that it is the combination of the domestic and international policy objectives, and particularly the objective of discriminating against nonresidents, that produces the key design features and complexities of Australia's dividend imputation system noted above. The consequence of this analysis that Australian companies which do not have nonresident shareholders are obliged to comply with requirements of the Australian dividend

imputation system that only exist because Australia wishes to discriminate against nonresident shareholders. Assuming that Australia wishes to continue this discrimination, this observation begs the question of whether it is possible to design a simpler form of corporate-shareholder taxation that produces equivalent results for resident shareholders to the dividend imputation system for those Australian companies that do not have nonresident shareholders. This in turn begs the further question of whether such a simpler system can be designed in a way that does not infringe the non-discrimination article in Australia's DTAs.

VII SOME CHARACTERISTICS OF PRIVATE COMPANIES IN AUSTRALIA

Before examining the design features of a simpler corporate-shareholder tax system for companies with no nonresident shareholders, it will be useful to obtain some estimate of the numbers of Australian companies in that category. Such an estimate should be of assistance in quantifying any reduction in the effective complexity of the tax system that might result from a simpler form of corporate-shareholder tax system. Public companies for tax purposes are not considered because of the existence of the secondary market in shares in listed companies. The secondary market means that it would be impossible to enforce a rule restricting optional dividend deduction treatment to listed companies with no nonresident shareholders.

In the 2002-2003 income year, 248,880 or 89 per cent of tax paying companies were private companies. These companies paid 36.74 per cent of the net company tax paid in 2002-2003. There were also 349,733 private companies which were either loss making or which had zero taxable income. This represented 97 per cent of non tax paying companies. The total income of all private companies in 2002-2003 was \$577,824,895,424 while the total taxable income of all private companies \$47,417,578,189. Of all private companies in 2002-2003 only 1,192 or 0.2 per cent paid more than \$1,000,000 in company tax. This represented 0.47 per cent of all tax paying private companies in 2002-2003.⁷⁹

Clearly a significant proportion of private companies do not have nonresident shareholders. Published Taxation Statistics do not directly disclose the number of nonresident shareholders in Australian companies but published statistics are consistent with this conclusion. In the 1999-2000 income year, the last year in which statistics on dividend withholding tax payments were separately reported, only 406 companies (excluding nominee companies of securities dealers) paid a total of \$60,849,000 in dividend withholding tax.⁸⁰ In 2002-2003 a total of 225 nontaxable and a total of 246 taxable private companies claimed a total of \$19,064,582 in s 46FA deductions. A total of nine non-taxable and five taxable public companies claimed a total of \$75,684,082 in s 46FA deductions in the same period.⁸¹ Given that some companies may have paid franked dividends to nonresident shareholders, the total number of private companies with nonresident shareholders is likely to be higher than the number of private companies that paid unfranked dividends or claimed s 46FA deductions but is still likely to be a clear minority of private companies.

⁷⁹ Australian Taxation Office ('ATO'), *Taxation Statistics 2002-03* (2005), 63, see especially Detailed Table 1: Company Tax: Selected Items, by Net Tax and Company Type, 2002-03 Income Year.

⁸⁰ ATO, *Taxation Statistics 1999-2000* (2001), Table 12.2.

⁸¹ ATO, *Taxation Statistics 2002-03* (2005), 63, Detailed Table 2.

VIII A BACK TO THE FUTURE SOLUTION FOR CLOSELY HELD COMPANIES: OPTIONAL DIVIDEND DEDUCTIBILITY

Where a company has only resident individual shareholders substantially equivalent results to those produced under the Australian dividend imputation system can be achieved more simply by permitting the company to use a form of dividend deduction system.⁸² To achieve taxation of distributed income (whether subject to corporate tax or not) at the resident individual shareholder's marginal rate the company would need to be permitted to carry tax losses resulting from dividend deductions both forward and back. Companies would not be permitted to carry losses back earlier than the year when they joined the dividend deduction system. Adjustments would need to be made in the value of losses carried forward or back for changes in the corporate tax rate between periods and an ordering rule for the application of losses attributable to different periods would need to be developed.

Because of the existence of the secondary market for shares in listed companies, such a system would not be appropriate for listed companies, or subsidiaries of listed companies. To prevent dividends being diverted to nonresidents through the use of intermediate entities it would also be necessary to limit the entities who could own shares or other interests in an optional dividend deduction company to resident individuals or intermediate entities in which the only stakeholders were resident individuals who were not trustees.

A company electing for dividend deduction treatment would not need to maintain a franking account or apply the franking rules to distributions, and would not be subject to either the anti-dividend streaming or the anti-franking credit trading rules. Shareholders receiving dividends would simply be taxed on the amount of the dividend without the need to apply the gross up and credit mechanism.

Companies in the imputation system (and other interposed entities such as trusts and partnerships) receiving dividends from dividend deduction companies would simply treat the dividend as they would an unfranked dividend.

A rule would need to be developed for the situation where a dividend deduction company received a franked dividend. One possibility here would be to either require the company to track franking credits on dividends received and to attach them to dividends that it paid using an ordering rule like the benchmark franking rule. Such an approach would reintroduce much of the complexity that a dividend deduction option was aimed at avoiding. Another approach would be to treat the dividend deduction company as a conduit in much the same way as partnerships and trusts are treated in the dividend imputation system. A difficulty with this approach is that the current rules giving conduit treatment to partnerships and trusts for imputation purposes are premised on the allocation of net income or of partnership losses on basis of entitlement rather than actual distribution.⁸³ By contrast, under a dividend deduction system corporate income is only assessable to a shareholder on distribution. To make conduit treatment of franking credits received by a dividend deduction company dependant on actual

⁸² If a policy decision were made to allow corporate tax preferences to pass through to closely held companies then a system similar to the US Subchapter S corporation would be another alternative. Arguably this option would be less problematic from an international point of view. It would, however, involve a significant shift of policy in relation to the tax treatment of distributions of corporate tax preferences. As this paper was written as a contribution within the parameters of a tax reform discussion in Australia that excludes fundamental changes in tax policy, this alternative will not be examined in detail in this paper. Incidentally, using a S corporation system to some extent would amount to a 'back to the future' solution given that between 1915 and 1922 the Commissioner allocated profits to shareholders where companies had not made a sufficient distribution. Allowing small companies the option to be taxed on a flow through basis was also proposed by the Asprey Committee. See Commonwealth, above n 73, [16.79]-[16.90].

⁸³ See C John Taylor, 'Problems with Franking Credits Flowing through Partnerships and Trusts: The 2004 Amendments and a Simpler Alternative' (2005) 34 *Australian Tax Review* 154, 188.

distribution would again impose the complexities of tracking and franking requirements on dividend deduction companies.

A better alternative may be to pursue the trust analogy from a different perspective and to only allow a shareholder in a dividend deduction company a franking credit if and to the extent that the franked distribution received was redistributed as a dividend in the year of receipt. Such a rule might be thought to be appropriate as a concessional measure and would be likely to lead to immediate redistributions of franked dividends received. It would not be practical to implement a rule of this nature where a company had more than one class of shareholder. Hence it would appear to be necessary that a company electing to receive dividend deduction treatment only have one class of shareholder. If this limitation were in place an alternative approach would be to regard franked dividends received by a dividend company as being included in the assessable income of shareholders irrespective of their actual distribution. This approach would be unfair to shareholders who had no control over the distributions of the company although similar unfairness might be thought to be present in the existing rules governing the taxation of some trusts and partnerships. Unfairness in the application of this rule to companies opting for dividend deduction treatment could be mitigated by imposing limits on the number of shareholders that a company choosing the dividend deduction option was permitted to have.

A company under an optional dividend deduction system would be able to choose to retain its tax preferred income and to distribute its taxable income. To the extent that it did this it would achieve the same end effect as does a company under Australia's dividend imputation system which chooses to retain tax preferred income and to distribute its taxed income as franked dividends. An optional dividend deduction system could produce a result that a company which distributed tax preferred income generated a larger loss carry forward which could then be offset against its future assessable income with the result that income of the later year could be retained tax free. As illustrated in Examples 1 and 2, the end result of such action would be equivalent to that produced in the Australian dividend imputation system if the company had only distributed its taxed income as franked dividends in both years. The combined corporate and shareholder tax paid under both systems would be identical if the companies adapted their dividend policies to the characteristics of the two corporate tax systems.

Example 1: Dividend Deduction System

Year One

Company

Profit	\$200
Income	\$100
Dividend	\$200
Deduction	\$200
Taxable Income	\$0
Loss carry fwd	(\$100)
Tax paid	\$0

Shareholder (48.5 per cent marginal rate plus Medicare levy assumed)

Dividend	\$200
Tax	\$ 97
After tax dividend	\$103
Total tax	\$ 97

Year Two

Company

Profit	\$100
Income	\$100
Loss carry fwd	(\$100)
Dividend	\$0
Taxable Income	\$0
Tax paid	\$0
Total tax	\$0

Total tax Year 1 and Year 2 = \$97

Example 2: Variable Credit Imputation System

Assume the facts in Example 1 with the variation that an Australian/New Zealand style variable credit dividend imputation system is used.

Year One

Company

Profit	\$200
Income	\$100
Tax	\$ 30
Franking credits	\$30
Dividend	\$70
Franking credit attached	\$30

Shareholder

Dividend	\$70
Gross up for franking credit	\$30
Grossed up dividend	\$100
Gross tax	\$48.50
Tax offset	\$30
Net tax	\$18.50
After tax dividend	\$51.50
Total tax	\$48.50

Year Two

Company

Profit	\$100
Income	\$100
Tax	\$30
Franking credits	\$30
Dividend	\$70
Franking credits attached	\$30

Shareholder

Dividend	\$ 70
Gross up for franking credit	\$ 30
Grossed up dividend	\$100
Gross tax	\$48.50
Tax offse	\$30
Net tax	\$18.50
After tax dividend	\$51.50
Total tax	\$48.50

Total tax Year 1 and Year 2 = \$97

Under an optional dividend deduction approach corporate income would only bear tax at the corporate rate so long as it remained in corporate solution. Hence introducing an optional

dividend deduction approach would not of itself do anything to counteract any tax planning that diverted personal services income to companies.

Assuming that capital gains on shares would continue to be given preferential tax treatment, there would be a continuing need for functionally equivalent rules to those dealing with tainted share capital accounts and anti-capital benefit streaming. Obviously debits in franking accounts could not be used as a sanction in these situations. In fact the solutions to these problems are likely to be simpler in a dividend deduction system. For example, the problem of profits being capitalised and then distributed as returns of capital could be dealt with by defining the share capital account as excluding an account containing capitalised profits or polluted in other ways and by continuing the current rule that distributions from a polluted share capital account are regarded as dividends. Similarly, the rules concerning off-market buy backs would need to be adapted to the optional dividend deduction system but this would not give rise to any significant problems. Deemed dividend rules for loans and debt forgiveness would also need to be adapted but there would be no point in applying deemed dividend rules in relation to excessive salary payments.

The tax treatment of returns on domestic debt and equity interests would be virtually identical under an optional dividend deduction system. The only difference of substance between the two treatments would be that losses attributed to dividend deductions could be carried both backward and forward under a dividend deduction system. Hence if an optional dividend deduction system were to be introduced it may be desirable to permit at least all dividend deduction companies to carry all losses back to the year of entry into the dividend deduction system as well as forward. If this were done then, as returns on both debt and equity would be deductible to the paying company, there would be no need to classify securities as being either debt or equity for domestic tax purposes.

Furthermore, as no interests in an optional dividend deduction company were controlled, directly or indirectly, by nonresidents, there would be no reason for applying the inbound thin capitalisation rules to them. In the case of the outbound thin capitalisation rules the concern would be that the company would obtain inflated deductions in respect of non-assessable non-exempt foreign source income. Hence, optional dividend deduction companies which did not derive non-assessable non-exempt could be exempted from both the debt and equity rules and the outbound thin capitalisation rules on an annual basis. Arguably there would be little need to apply the outbound thin capitalisation rules to an optional dividend deduction company whose only foreign source income was from portfolio investments. In any event, given that returns on both debt and equity would be fully deductible to the company there would be little point in distinguishing between debt and equity in limiting deductions in situations where optional dividend deduction companies did have non-assessable non-exempt foreign source income. In these cases it may be better to have a simpler limit based on an arbitrary per centage of the non-assessable non-exempt foreign source income derived by the optional dividend deduction company.

Hence it is argued that the legal complexity and associated compliance costs of a dividend deduction system at both the company and the shareholder level would be likely to be substantially less than the legal complexity and associated compliance costs of the current Australian dividend imputation system. As fewer companies and shareholders would be subject to the greater legal complexity and higher compliance costs of the dividend imputation system the effective complexity of the income tax system would also be likely to be reduced. It is also likely that administrative costs associated with a dividend deduction system would be lower than those associated with the current Australian dividend imputation system (auditing of dividend deduction companies which did not maintain franking accounts nor frank dividends would appear to be simpler as would assessing tax returns by

shareholders who generally would not be claiming a gross up and credit). This would also be likely to reduce the effective complexity of the income tax system.

For these benefits to arise the rules for electing for dividend deduction treatment would need to be simply and clearly set out. In order to be permitted to elect for dividend deduction treatment:

- The company would have to be a private company for tax purposes;
- The company could have only one class of shareholders;
- No shares or other interests in the company could be held by nonresidents;
- No shares or other interests in the company could be held by tax exempt entities;
- The only entities which would be permitted to own shares in the company would be resident individuals or other resident intermediate entities in which the only stakeholders were resident individuals who were not trustees;
- The number of shareholders in the company could not exceed a specified number (eg the number equal to the number of partners possible in a general partnership).

The company would also be excluded from the operation of the debt and equity rules and the thin capitalisation rules where no interests in the company were held by nonresidents and where it did not have any foreign branch profits or any non portfolio foreign source dividend income.

IX DOES THE PROPOSAL INFRINGE THE NON-DISCRIMINATION ARTICLE IN AUSTRALIA'S DTAs?

Only two of Australia's DTAs (those with the US and the UK) actually contain a non-discrimination article.⁸⁴ By a Protocol entered into in 1989⁸⁵ the following provision, art 27A, was inserted in the Australia – France DTA⁸⁶:

If, in an agreement for the avoidance of double taxation that is made after 19 June 1989 between Australia and a third State, being a State that is a member of the Organisation for Economic Co-operation and Development,

(a) [Paragraph (a) has not been extracted in this paper]

(b) there is included a Non-discrimination Article,

the Government of Australia shall immediately inform the Government of the French Republic in writing through the diplomatic channel and shall enter into negotiations with the Government of the French Republic, in the case of paragraph (a), to review the provisions specified in that paragraph in order to provide the same treatment for France as that provided for the third State and, in the case of paragraph (b), in order to provide the same treatment for France as that provided for the third State.

Similar provisions are contained in protocols to Australia's DTAs with Korea,⁸⁷ Finland,⁸⁸ Spain,⁸⁹ South Africa,⁹⁰ Romania,⁹¹ and Mexico.⁹² The DTAs with non-OECD countries

⁸⁴ As noted earlier the non-discrimination article in the *Australia – United States Double Taxation Convention* was not given the force of law by the *International Tax Agreements Act 1953* (Cth) s 6.

⁸⁵ *Protocol Amending the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 19 June 1989, Australia–France, [1990] ATS 26 (entered into force 19 July 1990).

⁸⁶ *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 13 April 1976, Australia–France, [1977] ATS 21 (entered into force 21 September 1977).

⁸⁷ *Protocol to the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 12 July 1982, Australia–Korea, [1984] ATS 2, para 6 (entered into force 1 January 1984).

merely make reference to subsequent treaties with a third country not to subsequent treaties with a third OECD country. All of the protocols containing provisions similar to article of the Australia – France DTA were entered into prior to Australia entering into its 2003 DTA with the UK.⁹³

There are some differences between the non-discrimination articles in the Australia – US DTA and the Australia – UK DTA. The provisions, however, that are relevant to whether the proposal infringes the article are substantially the same. Paragraph 1(c) of art 23 of the Australia – US DTA reads as follows:

a corporation of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is more burdensome than the taxation or connected requirements to which other similar corporations of the first-mentioned State in the same circumstances are or may be subjected.

The corresponding provision, which more closely follows the *OECD Model*, paragraph 4 of art 25 of the Australia – UK DTA reads as follows:

Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State in similar circumstances are or may be subjected.

For some years, the UK Inland Revenue's view of non-discrimination articles was that they are limited to discrimination against enterprises controlled by residents of the treaty partner state as compared with enterprises controlled by residents of a third state.⁹⁴ The better view, however, is that in determining whether there is a breach of the non-discrimination article in the *OECD Model* Convention (art 24(5)) a comparison should be made with an enterprise the shareholders or partners of which are exclusively residents.⁹⁵ For example, Vogel notes that Swedish and Dutch courts have found that rules granting relief on corporate reorganisations which were limited to cases in which both participants were created under domestic law infringed the non-discrimination article.⁹⁶ Most recently in the UK Court of Appeal decision in *NEC Semi Conductors Ltd v IRC* [2006] STC 606, Lloyd LJ (with whom Mummery LJ

⁸⁸ *Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 12 September 1984, Australia–Finland, [1986] ATS 6, para (b) (entered into force 28 March 1986).

⁸⁹ *Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 24 March 1992, Australia–Spain, [1992] ATS 41 (entered into force 10 December 1992).

⁹⁰ *Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 1 July 1999, Australia–South Africa, [1999] ATS 34, para 1 (entered into force 21 December 1999).

⁹¹ *Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 2 February 2000, Australia–Romania, [2001] ATS 4 (entered into force 11 April 2001).

⁹² *Protocol to the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 9 September 2002, Australia–Mexico, [2004] ATS 4, para 11(b) (entered into force 31 December 2003).

⁹³ *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 21 August 2003, Australia–United Kingdom, [2003] ATS 22 (entered into force 17 December 2003).

⁹⁴ Vogel, above n 57, 1331; J D B Oliver, 'Current Notes: Similar Enterprises' (1989) *British Tax Review* 141; J D B Oliver, 'Current Notes: Differential Treatment or Discrimination' (1993) *British Tax Review* 435.

⁹⁵ Vogel, above n 57, 1331; Oliver, 'Similar Enterprises', above n 94; Oliver, 'Differential Treatment or Discrimination', above n 94.

⁹⁶ Vogel, above n 57, 1331.

and Sedley LJ agreed on this point) said of the comparison to be made under the non-discrimination article,

What are the 'other similar enterprises'? It cannot mean other UK enterprises owned or controlled by residents of Japan; that would not prohibit any discrimination against Japanese owned UK subsidiaries generally. For the same reason it cannot mean UK companies owned or controlled by residents of countries other than the UK generally.....The comparison which is required by the non-discrimination article includes, among several possibilities, a comparison with a UK company wholly owned or controlled by a single shareholder. It is true that the non-discrimination article does not deal with whether the sole shareholder is an individual or a corporation, but it seems to me that it would be irrational to exclude that as a relevant element in the comparison, where the circumstances of the actual case are such that the foreign parent is a corporation. As Park J said 'it is necessary to assume that, if the actual company is a subsidiary of another company, then so is the hypothetical company.'⁹⁷

Hence under the better view, either denying deductions for dividends paid by optional dividend deduction companies to nonresidents or only permitting companies with no nonresident shareholders to become dividend deduction companies would infringe the non-discrimination article in both the US and UK DTAs.⁹⁸

For many years the US has not permitted nonresidents to be shareholders in IRC Subchapter S corporations.⁹⁹ The *Technical Explanation to the United States Model Double Taxation Convention*¹⁰⁰ argues that this restriction does not infringe the non-discrimination article. The *Technical Explanation* argues that while resident shareholders in an S corporation are taxed by reference to the pro rata shares of the income, losses, deductions and credits of the corporation that are allocated to them, nonresident aliens are not taxed on a net basis and thus does not generally take into account corporate losses, deductions or credits. Hence the *Technical Explanation* characterises the exclusion of nonresident alien shareholders as arising not because the shareholders are foreign but because they are not taxed on a net basis.¹⁰¹ The argument has not impressed the commentators who point out that the problem would be easily resolved by applying to S corporations the withholding tax rules that the US applies to partnerships with nonresident partners.¹⁰²

Irrespective of the merits or otherwise of the arguments on this point in the US *Technical Explanation*, they would not be able to be used without modification to justify denial of dividend deduction company status to companies with nonresident shareholders. Analogous logic to that used in the *Technical Explanation*, however, may provide a justification for such treatment. This would be to ask why Australia would want to exclude nonresident shareholders from owning shares in optional dividend deduction companies. The answer is not so we can discriminate against companies with nonresident shareholders but rather a fear of erosion of our corporate shareholder tax base through a combination of excessive distributions and low treaty rates of withholding tax. Once the problem is characterised as one of preventing base erosion it is possible to identify other classes of taxpayer that Australia would want to exclude from being shareholders in optional dividend deduction

⁹⁷ *NEC Semi Conductors Ltd v IRC* [2006] STC 606, [34]-[41].

⁹⁸ Avery Jones et al, above n 68, 443. The comment is made in relation to split rate systems.

⁹⁹ 26 USC § 1361(b)(1)(C). For a discussion of the general requirements applying to US Subchapter S corporations see J K Mc Nulty, *Federal Income Taxation of S Corporations* (1992); Eustice and Kuntz, *Federal Income Taxation of S Corporations* (1985).

¹⁰⁰ US Treasury, *Technical Explanation to the United States Model Income Taxation Convention* <<http://www.ustreas.gov/offices/tax-policy/library/techxpln.pdf>>.

¹⁰¹ *Ibid* [360].

¹⁰² American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, 'Report on the Comparison of S Corporations and Partnerships: Part I' (1991) 44 *The Tax Lawyer* 483; American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, 'Report on the Comparison of S Corporations and Partnerships: Part II' (1991) 44 *The Tax Lawyer* 813, recommendation 4, [4.2]; S H Goldberg and P A Glicklich, 'Treaty Based Non-Discrimination: Now You See It Now You Don't' (1992) 1 *Florida Tax Review* 51, 105.

companies. Base erosion would be a risk in all instances where tax exempt entities were shareholders in optional dividend deduction companies. Given that some resident tax exempt entities are currently entitled to fully refundable franking credits, to minimise the risk of infringing the non-discrimination article, it would be desirable to exclude those entities from restrictions on share ownership in optional dividend deduction companies. If both nonresident shareholders and certain resident tax exempt shareholders were excluded from owning shares in optional dividend deduction companies it would be arguable that the exclusion was not based on the residential status of the shareholder but on the risk of erosion of the corporate-shareholder tax base presented by ownership of shares in optional dividend deduction companies by tax exempt or low taxed shareholders. This approach would parallel that taken in the existing regime denying the ability to frank dividends to exempting entities.

Alternatively, one of the suggestions made by commentators on non-discrimination problems with the US Subchapter S corporation might be able to be adapted to resolve base erosion concerns if nonresidents were permitted to own shares in optional dividend deduction companies. This is the suggestion that nonresidents be permitted to hold shares in Subchapter S corporations if they elect to be taxed on a net basis.¹⁰³ Applying this suggestion in the context of an optional dividend deduction system, however, may be more complex as shareholders in a Subchapter S corporation are not taxed on dividends and hence the suggestion would not infringe limits on dividend withholding tax in US DTAs. In an optional dividend deduction system shareholders are taxed on dividends received and Australia's DTAs impose limits on the tax the Australia can levy on dividends paid to nonresident shareholders. Allowing companies with nonresident shareholders to be optional dividend deduction companies if the nonresident shareholders elect to be taxed at standard nonresident rates on a net basis would not infringe the non-discrimination article but might infringe the dividend article in Australia's DTAs.

Interestingly, there are Australian precedents for allowing a nonresident shareholder the option to be taxed on dividends on a net assessment basis rather than on a gross withholding basis. Australia first introduced a withholding tax on dividends in 1959. Although the withholding tax was at a flat rate and was levied on the gross dividend income, nonresidents were given the option under *ITAA36* s 128D(2) to elect to be taxed on an assessment basis on the dividend income under *ITAA36* s 44(1)(b). If the election was made, s 128D(3) required the nonresident to file a return disclosing the nonresident's dividend income and the nonresident's worldwide income. A refundable credit against the tax on an assessment basis for withholding tax paid on the dividend was given under *ITAA36* s 128E(1)(a). Where tax on an assessment basis exceeded the withholding tax and the tax on an assessment basis that would have been payable if the *ITAA36* s 128D(2) election had not been made, *ITAA36* s 128E(1)(b) entitled the nonresident to a non refundable rebate of the excess.¹⁰⁴ The rebate under s 128E(1)(b) meant that it would have been difficult to argue that the option to be taxed

¹⁰³ Goldberg and Glicklich, above n 102, 105.

¹⁰⁴ The election was introduced largely to accommodate NZ resident shareholders. In 1959 NZ continued to exempt dividends sourced in British Commonwealth countries from NZ tax. This meant that NZ shareholders who had interest expenses relevant to gaining dividends from Australian companies could not obtain a NZ tax deduction for those expenses. Hence, even though the rate of dividend withholding tax might be lower than the marginal rate which would otherwise apply to the shareholder the fact that it was levied on a gross rather than a net basis could mean that, where the NZ shareholder had expenses (typically interest) relevant to gaining her or his Australian dividend income the effective tax rate on a withholding basis could be higher than the effective rate on an assessment basis. The election enabled a NZ shareholder to claim interest and other expenses on her or his Australian source dividends as a deduction against tax levied by Australia on an assessment basis. The background to the election is explained in Commonwealth Committee on Taxation, *Report* (1961), 108-10.

on a net assessment basis infringed the limits on Australia's taxation of dividends in its then current DTAs.

The purpose behind allowing nonresidents to be shareholders in optional dividend deduction companies if they elected to be taxed on a net assessment basis (with credits for any prior withholding tax) would be to prevent corporate-shareholder base erosion. The existence of a such a rebate like the former *ITAA36* s 128E(1)(b) rebate would defeat that purpose. Hence, despite Australia's previous experience with optional net basis taxation of dividends for nonresidents the question remains whether such treatment without a refundable rebate would infringe the dividend articles in Australia's DTAs.

Consideration of that question involves the issue of whether a taxpayer who has elected to be taxed at higher rates on a net basis on dividends can thereafter claim that the lower treaty rates of tax on a gross basis should have applied. The *Technical Explanation to the United States Model Income Taxation Convention* may provide some basis for an argument that there is no infringement of dividend article in these circumstances. The *Technical Explanation* expresses the view that the dividend article is not infringed if tax is withheld at the time of payment at full statutory rates and the treaty benefit provided by means of a subsequent refund.¹⁰⁵ While such procedure may be justified as a means of verifying the nonresident status of the shareholder, when it depends on the refund process being initiated by the shareholder it might not be thought to be too far removed from a process in which the shareholder elects to be taxed at full statutory rates.

On balance the alternative of restricting shareholding in optional dividend deduction companies to nonresidents and those tax exempts which are not currently entitled to franking credit refunds would appear to be the option least likely to infringe the non-discrimination article in Australia's DTAs and the one most closely analogous to other current Australian practices.

X INTERNATIONAL OBLIGATIONS AND THE COMPLEXITY OF DOMESTIC TAX DESIGN

I began this paper by recalling an incident reported in Kevin Brownlow's *The Parade's Gone By*. Symmetry requires therefore that I should finish it by recalling a quote reported in the same book. Brownlow chose to end his book with a quote from America's sweetheart, the Canadian, Mary Pickford. The quote was 'It would have been more logical if silent pictures had grown out of the talkie instead of the other way around.' Film critic Walter Kerr in his *The Silent Clowns* after wondering what the woman could have meant by this quote, why is it logical to wind up with a black and white dance of silent ghosts, concludes that it is artistically apt. Kerr's conclusion is that 'all art begins with a taking away'; that audiences responses to less complete canvasses are more engaged, responsive and intelligent than they are to those that are over cluttered with detail.

An analogy can be drawn with the development of Australian corporate-shareholder taxation since 1915. We have moved from an elegant and simple system to a complex and cluttered one which arguably distorts rather than promotes constructive business activity in response to it. No doubt, some of our technical mechanisms (such as our withholding tax regimes, arbitration procedures and exchange of information arrangements) represent significant improvements on their 1915 equivalents. Paradoxically many of the complexities in our system are consequences of our bilateral DTA network locking us into the international taxation consensus and compromises that emerged following World War I. Perhaps the focus on structural issues in the current tax reform debate in Australia represents a belated recognition of the art of taking away, of stripping down the system to its essentials. Certainly

¹⁰⁵ Ibid 45-6.

the argument of this paper is that the corporate-shareholder tax system is more complex than it needs to be for the majority of companies and, but for international considerations, much of that complexity would never have existed. The submission of this paper is that for these companies that complexity can be stripped away without a significant risk of infringing Australia's DTAs obligations.

It has to be acknowledged, however, that international treaty obligations may limit Australia's freedom of action in simplifying its corporate-shareholder taxation regime. Clearly one of the consequences of globalisation increasingly is the limitations that it, and international agreements entered into as part of and in response to it, places on national sovereignty. The talkie to silent analogy when viewed from a different perspective can also be helpful in developing a response to this concern. Historically income tax systems developed first as domestic systems and co-ordinated rules for their international interaction only emerged later. In broad terms the bi-lateral treaty networks that have developed since World War II have been largely concerned with limiting the taxing rights that contracting states would otherwise enjoy under their domestic law. As Vann has argued the *OECD Model* based as it is on a schedular approach and on compromises between residence and source taxation represents the post World War I consensus not the post World War II consensus.¹⁰⁶ Over time the result was that this superimposition of international rules based on a schedular approach as a gloss on disparate domestic systems increased the complexity of the domestic systems. It may have been more logical to have developed rules for the international interaction of systems first and to then design the domestic systems with the international rules in mind. The mobility of capital that is the defining characteristic of globalisation and the financial engineering that has developed symbiotically with it are increasingly highlighting the shortcomings of the schedular and classical approach of the post World War I consensus as embodied in the *OECD Model*.

Perhaps the time has come to truly reconsider international rules for the interaction of tax systems to allow for the flexible development of domestic rules built on them. One back to the future suggestion is Harris' suggestion of developing a composite income tax system based on a refined version of the UK system of Dominion Income Tax Relief which operated from the 1920s to the mid to late 1940s.¹⁰⁷ The fundamental feature of this approach is that source countries would tax nonresidents at their source rate reflecting the services provided to them while residence countries would give residents foreign tax credits based on the residence country's source rate. As was the case with the UK system of Dominion Income Tax Relief, a composite tax system would be compatible with the international operation of a wide variety of corporate tax systems including an optional dividend deduction system.¹⁰⁸

¹⁰⁶ R J Vann, 'A Model Tax Treaty for the Asia-Pacific Region?' (1991) 45 *Bulletin for International Fiscal Documentation* 99.

¹⁰⁷ See the discussion in Harris, above n 41, chs 7 and 8.

¹⁰⁸ Harris, above n 41, 518.

WHY TAXING THE MICRO-BUSINESS IS NOT SIMPLE — A CAUTIONARY TALE FROM THE ‘OLD WORLD’

JUDITH FREEDMAN*

This article tells a cautionary tale of the pitfalls surrounding small business tax policy, illustrated with some examples from the United Kingdom. The heterogeneous nature of the small business sector makes it unlikely that tax reliefs and incentives based purely on size will be well targeted. Many small firms are not entrepreneurial and do not wish to grow but it is nonetheless predictable and rational for them to seek to take advantage of any tax incentives made available on the basis of size or legal organisational form. In addition, tax policy that concentrates on the provision of incentives for small firms is likely to result in complexity, the proliferation of thresholds and frequency of change, the costs of which may well outweigh any advantages to the smallest firms. The compliance costs resulting from taxation are regressive, but so too are the costs of dealing with special reliefs. A central problem relates to the drawing of a line between income from capital and income from labour for tax purposes. In seeking to do this, the tax system needs to have regard to legal as well as economic realities. Small business tax policy needs to be based on a better understanding of the way in which businesses form and develop and their motivations and difficulties. Stability and predictability may be more important than special reliefs.

I INTRODUCTION TO THE TALE

According to Wikipedia,² a cautionary tale is told to warn its hearers of a danger. The encyclopaedia states that there are three essential parts to a cautionary tale — ‘First, a taboo or prohibition is stated: some act, location, or thing is said to be dangerous. Then, the narrative itself is told: someone disregarded the warning and performed the forbidden act. Finally, the violator comes to an unpleasant fate, which is frequently related in large and grisly detail.’ The encyclopaedia goes on to cite Lewis Carroll in Alice’s Adventures in Wonderland:

Alice had read several nice little histories about children who had got burnt, and eaten up by wild beasts and other unpleasant things, all because they *would* not remember the simple rules their friends had taught them: such as, that a red-hot poker will burn you if you hold it too long; and that if you cut your finger *very* deeply with a knife, it usually bleeds; and she had never forgotten that, if you drink much from a bottle marked ‘poison,’ it is almost certain to disagree with you, sooner or later.

Above all, cautionary tales underline the importance of learning from experience and not ignoring the advice of others. In accordance with this formula I am first going to explain the dangers inherent in designing small business policy and, second, how the United Kingdom (‘UK’) government has disregarded all the warnings it should have noted. I shall then relate, although perhaps not in all its grisly detail, what has happened as a result. In expounding this story I shall also refer to other examples of policy makers disregarding dangers. I shall discuss how the unfortunate outcome which has befallen the UK Chancellor, Gordon Brown and his team might be avoided by better behaved policy makers who take more care to listen to advice given. Indeed, to be fair, we shall note how the UK Treasury seems to be beginning to learn from its experience. Finally it will be argued that some radical new thinking may be

* KPMG Professor of Taxation Law, University of Oxford. This article was prepared to be delivered as a lecture at the 18th Annual Conference of the Australasian Tax Teachers Association at the University of Melbourne Law School. Thanks to those who have commented on the paper already. I would welcome further comments.

² Wikipedia, ‘Cautionary Tale’ <http://en.wikipedia.org/wiki/Cautionary_tale>.

needed but that there must be consultation and testing rather than experimentation on the small business sector.

Much of the discussion here is based on UK experiences and UK statistics, and care must be taken not to imply that the characteristics of small firms and their problems will be identical in all jurisdictions and, even within jurisdictions, across all sectors. Many of the lessons drawn, however, do seem to be relevant more widely and the debates around tax policy making for small businesses in Australia and the United States of America ('US') seem remarkably similar to those in the UK.

II THE WARNING — DANGERS INHERENT IN SMALL BUSINESS TAX DESIGN

A *The Pitfalls Outlined*

There is a tendency to believe that because small businesses do not involve as many people as large businesses and because the sums of money concerned are lower, that their affairs should be simpler. This assumption is mistaken. Micro-businesses may be set up by just one person or they may emerge from acquaintances, friendships, blood relationships and marriage. Since people and their relationships are not simple, micro-businesses, though small, are far from simple organisations. It is unlikely that their tax affairs will be simple either and sometimes attempts to simplify, or to provide relief for small business, can actually create complexity: the concept of 'complex deregulation' noted previously by this author in connection with company law.³ For example, the creation of elections and options for small businesses, intended to assist them, may create expense by increasing choice and the need to take advice. Although there may be a resulting tax saving, this might be outweighed by the fees they have to pay to advisers and the management time taken in learning about and considering the available elections.

In a tax context, we might extend this concept to one of 'complex simplification'. This is related to a phenomenon that has been noted in connection with tax simplification by Steven Dean of Brooklyn Law School: that of 'attractive complexity'.⁴ Dean's argument is that relying on taxpayer preferences to guide simplification efforts may produce forms of deregulation that are not simplifications at all. The example he gives is that of the check-the-box entity regime in the US which resulted from taxpayer pressure and may well have been popular as a means of reducing tax burdens, but which most certainly has not produced tax simplification, but rather opportunities for more choice and manipulation. Similarly, small business pressure groups might lobby for forms of relief but find that they do not ultimately produce simplification, as in the case of the ill-fated nil rate of corporation tax in the UK, now repealed. This is the subject of further discussion below.

This paper will focus on micro-businesses (defined here as businesses with fewer than 10 employees⁵) because the arguments are most marked in relation to them — their profits may be very low indeed and by definition there are few people involved but they are far more complex in the issues they raise than many would predict from those facts.

The main causes of complexity can be classified as follows:

- 1 The desire to achieve a range of objectives through taxation — not only revenue-raising, but also micro and macroeconomic management. The objectives of different government

³ On the phenomenon of complex deregulation in company law, see Judith Freedman, 'One Size Fits All — Small Business and Competitive Legal Forms' (2003) 3(1) *Journal of Corporate Law Studies* 123.

⁴ Steven Dean, 'Attractive Complexity: Tax Deregulation, the Check-the-Box Election and the Future of Tax Simplification' (2005/6) 34 *Hofstra Law Review* 405.

⁵ A definition used by the European Observatory for Small and Medium Enterprises of the European Union: <http://europa.eu.int/comm/enterprise/library/lib-entrepreneurship/series_observatory.htm>.

departments may conflict and policymaking may not be ‘joined-up’ due to lack of communication.

- 2 The failure to understand the nature of the micro-business as distinct from the small business, including the failure to recognise the motivations for setting up such a business. Business organisations often represent the larger small businesses for the simple reason that micro-businesses are by definition non-joiners of organisations. Complexity may be more attractive to larger small firms than to micro-firms because they may have more to gain, but there will be losers as well as winners from such ‘attractive complexity’.⁶
- 3 The existence of many different legal forms for small businesses which may be adopted by micro-business and the fact that there may be commercial or legal (for example, employment law) reasons why one of these is preferable to another. There are also family and other personal relationships interacting around the micro-business, which may complicate the picture.
- 4 The failure to appreciate the regressivity of compliance costs and to ‘think small first’. This may be a more layered problem than is fully appreciated: burdens are not always considered in a joined-up way. For example, removal of a tax accounting requirement may not assist, and could even hinder, if the requirement exists anyway for corporation law or commercial reasons.
- 5 The proliferation of different size thresholds for different purposes. Thresholds may create barriers to growth and increase compliance costs at the borders. Deregulation and reliefs may increase complexity to give ‘complex deregulation’ or ‘complex simplification’.⁷
- 6 The inclination to change regimes frequently, often with well-intentioned aims, but failing to appreciate the cost of change. This is coupled with an underestimation of the importance of stability to the micro-business. Stability is important to the business community generally but even more so to micro-businesses because of the regressive costs of change and learning new systems and rules.

B The Pitfalls in More Detail

Each of these causes of complexity is contentious in some way and so more detailed discussion and justification of the argument that these are ‘pitfalls’ is required.

1 Diverting from the Primary Objectives of Taxation

Whilst the purist might argue that taxation should be used only for revenue-raising, it is a fact of life that governments will also wish to use the tax system to manage the economy at both a macro and a micro level. Governments seem particularly inclined to attempt to use the tax system to create special incentives and relief in the case of small businesses. The two key justifications for this are that there are market failures created by the power of larger firms, asymmetric information, financing difficulties and market barriers and that there are structural costs of being small, such as lack of ability to set off losses against profits elsewhere and, generally, the regressivity of tax burdens. In addition, the importance placed on small businesses in terms of the economy and job generation are frequently relied upon to justify tax provisions targeted at small businesses.⁸

⁶ Dean, above n 4.

⁷ Freedman, above n 3.

⁸ See OECD, *Taxation and Small Businesses* (1994) discussed further in Judith Freedman, ‘Small Business Taxation: Policy Issues and the UK’ in Neil Warren (ed), *Taxing Small Business — Developing Good Tax Policies* (Australian Tax Research Foundation Conference Series, No 23, 2003).

Although there may be justifications for special small business tax relief, they are not always made clear and sometimes this rationale has not been carefully applied. In addition, even where the rationale is applied, in practice the different forms of relief are often badly targeted. A further problem is that incentives can often be used by businesses that the legislature did not originally intend to benefit. This will then be described as avoidance or even abuse by governments, although arguably it is simply a rational reaction to the structures created by the legislation. Even if the targeted firms are the ones to benefit, this may distort the market in unintended ways by, for example, resulting in the allocation of resources to small firms in circumstances where larger firms could use them more efficiently.

A report on best practice by the OECD points out that a tax paid by small business will rarely coincide closely with the target group — that is the tax, be it personal income tax, corporation tax, or general consumption taxes, will affect a much wider group. There is no such thing as a small business tax *per se*. Of course this is dealt with often by recreating sub-groups for tax purposes but this creates new thresholds and thus barriers and complexities. As the OECD points out, this lack of precise targeting of tax-based measures must be measured against the attractions of using existing administrative machinery. The report lists the following as areas where the tax system has a potential role: limiting the cost disadvantages faced by small businesses in complying with tax legislation; encouraging the creation of new small businesses; ensuring the continuation of small businesses when control passes from the founder of the firm to another person.⁹

2 *The Nature of the Micro-Business*

The aim of small business tax relief is generally to encourage the growing, rather than the static, small business in order to encourage job creation and economic growth.¹⁰ The very smallest firms may be start up firms which intend to grow — equally they may be small because they like it that way, known as ‘life-style’ businesses. For many small business owners the motivation to set up their own business is to escape bureaucracy, to balance work and family responsibilities and to obtain autonomy. They are often reluctant to grow and in particular, reluctant to take on employees.¹¹ Research has shown consistently that only about half of small businesses wish to grow¹² and the larger the small business the more likely it is to want to grow.¹³ The UK Small Business Service’s 2004 *Annual Small Business Survey* states that only 11 per cent of small businesses¹⁴ consider themselves to be prevented from growing when they wish to do so. Many of these businesses which do not wish to grow can be considered life-style businesses. The need to make a profit is not irrelevant since obviously few businesses can survive if they do not do so, but many of these businesses also have other measures of satisfaction and criteria for assessing whether their business ventures

⁹ OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, 22 June 1997.

¹⁰ See, eg, Her Majesty’s Revenue and Customs (‘HMRC’), PN01 December 2005 <<http://www.hmrc.gov.uk/pbr2005/pn01.pdf>> and HMRC, *Partial Regulatory Impact Assessment for Changes to Corporation Tax Structure* (2005) <<http://www.hmrc.gov.uk/ria/ct-structure.pdf>>; although other attributes of small business are also recognised by government such as diffusing new ideas and technologies and forming part of the bedrock of local communities and contributing to social cohesion: HM Treasury, ‘Small Companies, the Self-Employed and the Tax System’ (Discussion Paper, December 2004) <http://www.hmrc.gov.uk/pbr2004/small_companies.pdf>.

¹¹ James Curran, *Bolton 15 Years On: A Review and Analysis of Small Business Research in Britain, 1971-1986* (1986); Elizabeth Walker and Alan Brown, ‘What Success Factors Are Important to Small Business Owners?’ (2004) 22 *International Small Business Journal* 577.

¹² Colin Gray, ‘Growth-Oriented and the Small Firm’ in Kevin Caley et al (eds), *Small Enterprise Development: Policy and Practice in Action* (1992); Small Business Service, *Annual Small Business Survey* (2004).

¹³ Small Business Service, *Annual Small Business Survey* (2004).

¹⁴ Defined in that survey as businesses with zero to 249 employees.

are successful. Personal satisfaction, pride in the job and a flexible lifestyle may be valued more highly than wealth creation.¹⁵

Relief targeted to the very bottom end of the small business sector, whether by number of employees, turnover, profit or some other measure, will catch both these groups indiscriminately and so, for governments wishing to promote growth, will have a deadweight cost. Although there is an increasing volume of research on the characteristics of small businesses and, in the UK, much of this is government sponsored and published by the Small Business Service, there has been a failure in recent years by the Treasury and Inland Revenue to take this information on board when engaging in tax policy design. There are welcome signs in the latest pre-budget review that this may be improving, in part perhaps as a result of the creation of a new and strengthened tax policy function in the Treasury following a recent review of the UK revenue departments.¹⁶ Encouragingly, the announcement by the Australian Board of Taxation that it is undertaking a scoping study of tax compliance costs facing the small business sector states expressly that it will work closely with small business and especially micro-business in undertaking the study.¹⁷

Micro-businesses matter. They make up the majority of all businesses in number of enterprises (although not of course in terms of employment or contribution to the economy). In the European Union in 2003,¹⁸ 92 per cent of all enterprises were micro-enterprises under the definition given above.¹⁹ They lag behind in terms of value added per person occupied, but nevertheless employed an average of three people per enterprise, although half of these micro-enterprises had no employees at all.

There is a similar picture in the UK statistics. At the start of 2004, there were an estimated 4.3 million business enterprises in the UK, about four million (93 per cent) of which were micro-businesses. 3.1 million (72.8 per cent) had no employees at all. Micro-businesses accounted for around 33 per cent of total employment and 23 per cent of turnover.²⁰ Although clearly each micro-business on its own is less significant and may even be less efficient than any single small, medium or large business, on no measure could micro-businesses be considered unimportant as a sector. It is also clear, however, that this sector will include a great variety of businesses with different motivations so that it is necessary to look at the range of types of businesses being dealt with.

If tax systems are being designed to create incentives to grow, for example, then it is likely that those incentives will only operate in the way intended in relation to businesses which want to grow in the first place. Other business owners might take the benefits of the incentives without having any intention of growing. The fact that wealth creation is not their only motivation and that they do not wish to grow does not mean that they will not take advantage of any means of cutting the tax cost which is offered to them. This might be argued to be an unintended consequence. Sometimes unintended consequences are inevitable and difficult to avoid, but in this case the consequences of offering tax breaks to all micro-businesses is predictable. The breaks will apply to as many firms that do not wish to grow as to those that have a growth orientation.

¹⁵ Walker and Brown, above n 11.

¹⁶ HM Treasury, *Financing Britain's Future: Review of the Revenue Departments*, Cm 6163 (2004) ('O'Donnell Review'). On this review, see Christopher Wales, 'The Implications of the O'Donnell Review for the making of Tax Policy in the UK' [2004] *British Tax Review* 543.

¹⁷ Australian Board of Taxation, *Small Business Tax Compliance Costs Study* (2005) <www.taxboard.gov.au/content/tax_compliance_costs.asp>.

¹⁸ Nineteen countries at that time (including European Free Trade Association countries).

¹⁹ Observatory of European SMEs, European Commission, *SMEs in Europe 2003*, Report No 7 (2003).

²⁰ National Statistics, *SME Statistics UK 2004* (2005).

3 *Existence of Different Legal Forms*

The ingenuity of lawyers in devising legal forms for the purpose of doing business has created concepts of major importance without which business as we know it would not operate, in particular limited liability. At the same time, this ingenuity creates complexity for the micro-business since one of the first decisions that a person setting up in business has to make is what legal form to adopt. To an economist, incorporation implies a separation of capital from labour and management from control. The corporate legal form is structured for this purpose but does not require it. Because shareholders, directors and employees may be one and the same people or even one person, the legal form does not necessarily result in such a separation. The UK system of business organisations encourages incorporation by making it cheap and easy. This is an explicit policy of recent company law reform enacted in the *Companies Act 2006*. In a guide to the new legislation for small business, the government states that '[t]he purpose of company law and corporate governance is to promote enterprise and stimulate investment. We are determined to ensure that our system makes it easy to set up and grow a business'.²¹

Leaving aside whether this is an adequate description of the function of company law, it is certainly indicative of the widely held belief that encouraging incorporation encourages enterprise and growth. It is clearly important not to put barriers in the way of those needing to incorporate but whether incorporation should be encouraged is another matter. Of course, a growing enterprise will eventually need some kind of mechanism for organising its business and procuring limited liability but it does not need to be incorporation. In Australia, business trusts are widely used although they usually use incorporated companies as part of the arrangements. In the US there are more legal forms available, notably the limited liability company ('LLC'), although the proliferation of legal forms there is beginning to be seen as problematic. In the UK the recently created limited liability partnership ('LLP') has been seen by some as a potential vehicle for small firms but that was not the purpose for which it was designed and it is not entirely suitable for this purpose.²² The tax advantages of incorporation in the UK have been amongst the factors limiting the development of the LLP for small firms to date. Incorporation can prove costly eventually and may be a poor idea if the owners do not really understand that they are creating a separate entity. The advantage of limited liability may be illusory as may other supposed advantages of incorporation such as the ability to raise finance more easily where the firm is in fact very small.²³ Yet UK government policy is to encourage incorporation for even the smallest businesses whereas in the case of taxation, as we shall see, incorporation of the very smallest firms may be seen as an abuse in some circumstances — a rather confusing picture for a small business owner and not the stuff of joined-up government.

Whilst some research suggests that incorporated businesses are more likely to grow than those which are unincorporated,²⁴ it does not follow that incorporation is a contributory factor

²¹ DTI, *Company Law Reform: Small Business Summary* (2005).

²² Judith Freedman 'Limited Liability Partnerships in the United Kingdom — Do They Have a Role, for Small Firms?' (2001) 26 *Journal of Corporation Law* 897. For a different view see Geoffrey Morse 'Partnership Law Reform in the UK' in Joseph McCahery, Theo Raaijmakers and Erik Vermeulen (eds), *The Governance of Close Corporations and Partnerships* (2004). There has been no rush to use LLPs — 3,321 were registered in 2003-4 and 5,191 in 2004-5 — a tiny number compared with new company incorporations (DTI, *Companies in 2003–2004* (2004) <<http://www.dti.gov.uk/files/file10681.pdf>>; DTI, *Companies in 2004-2005* (2005) Table E4 <<http://www.dti.gov.uk/files/file13424.pdf>>).

²³ Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317.

²⁴ David J Storey, *Understanding the Small Business Sector* (1994), 140. Note that this is based on research undertaken before incorporation was made more attractive for very small companies by changes in the tax system. In addition, Storey refers to an empirical project undertaken by this author which found 40 per cent

in growth — those who choose to use incorporation may be at a certain stage of the business cycle or may be better advised or more motivated in the first place. Targeting tax relief to incorporated as opposed to unincorporated businesses will not result in that relief reaching only businesses that grow or wish to grow. Implementation of such relief will change behaviour and thus change the set of businesses incorporating so that it begins to include more businesses which do not wish to grow.

Neutrality in the tax system as far as choice of legal form is concerned is an obvious desideratum but this is very difficult to achieve because incorporation has a degree of legal substance which makes companies genuinely different from unincorporated firms in terms of consequences for the parties concerned. Very often, the concern is that incorporation increases tax due to the element of double taxation on corporations.²⁵ In the case of the micro-business in the UK the issue is rather different and arises from the fact that business income, labour income and income from capital are separated from each other in what may seem to be an artificial way but which is a natural consequence of the rights and duties created in law.

Short of a complete move away from income as a tax base, which is outside the scope of this paper,²⁶ this could be dealt with in various ways. First, income from capital and income from labour could be taxed identically. Unless owner controlled firms can be dealt with differently from others, this is unlikely to occur, due to the mobility of capital which is forcing down tax rates on returns from capital globally although the differences could be reduced. Owner controlled companies could be taxed as if they were unincorporated²⁷ but attempting to do this would give rise to serious definitional problems. The aim would be to differentiate companies where the owners could adjust the amount paid out by way of salary and that paid as a return of income from those which could not but this is not going to be an easy dividing line.

Second, the tax legislation could look through the corporate veil by treating returns on capital as employment income in some circumstances — the difficulty here again is definitional as it is necessary to define those circumstances. This is a problem the UK has encountered, as discussed below.²⁸

A third way of achieving a measure of neutrality might be by treating an unincorporated business as if it had some kind of separate entity status so that the labour income of such a firm was taxed in a similar way to returns on capital but employment income would continue to be taxed differently. That exchanges one distortion for another and provides an even greater incentive than now to convert employment into self-employment. The President's Advisory Panel in the US has recommended a greater separation between business and personal income for unincorporated firms in its Simplified Income Tax Plan but this seems to

of incorporated firms in her sample had started life as unincorporated firms and he admits that therefore any association between limited company status and growth could be considered to be reversed, with the change in legal status a consequence rather than the cause of growth: Judith Freedman and Michael Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in Alan Hughes and David Storey (eds), *Finance and the Small Firm* (1994).

²⁵ US President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (2005) ch 5: <<http://www.taxreformpanel.gov/final-report>>.

²⁶ That is, a move to consumption taxes for individuals and businesses. Even in such a system, it is still necessary to allocate the tax base to different legal persons.

²⁷ Tax Faculty of the ICAEW, *Small Companies, the Self-employed and the Tax System*, TAXREP 22/05 (April 2005).

²⁸ The so-called 'IR 35 legislation'. For a scheme used in the Nordic countries to deal with the same problem, see Peter Birch Sorensen, 'Neutral Taxation of Shareholder Income' (2005) 12 *International Tax and Public Finance* 277.

be largely intended as an administrative measure, and one of doubtful efficacy since it is hard to see how the separation would be defined and policed.²⁹

A further reason for the complexity of different legal forms of micro-firms is that they interact with the underlying personal relationships. A business partnership may exist between friends or a married couple. Profit splitting and allocation of interests in capital may occur in a non-commercial way and this will exacerbate the difficulties created by the differences in taxation of labour and capital.

4 *Regressivity and the Removal of Burdens*

All businesses complain of complexity but it has been clearly established that administrative burdens, especially those in the area of taxation, are regressive in nature. Compliance costs are regressive, especially where a Value-Added Tax ('VAT') or Goods and Services Tax ('GST') is involved.³⁰ Thus small businesses are at a disadvantage.

Governments recognise that the administrative burden of taxation on small businesses is one of the most serious areas of complaint and take seriously the need to reduce such burdens. Both the UK and Australia are currently consulting on compliance costs of small businesses.³¹ Consideration of burdens as if they were distinct from the substantive law is not, however, likely to help significantly and the starting point needs to be the underlying policy of the law.

The regressivity of compliance costs is the result of diseconomies of scale, the complexity of the tax system and the learning curve necessary for acquiring the knowledge to deal with that system, especially if it changes frequently.³² The best way to assist small businesses will be to reduce complexity but as already shown the micro-business is a complex animal. The mismatch between legal and economic form, discussed above, is a good example of a layer of convolution which may require *more* complex regulation for the micro-business than for the publicly quoted company. Attempts at providing deregulation or relief can result in increased complexity also if they are not properly thought through. The introduction of elective simplified systems which need to be compared with existing systems to assess whether they will produce a saving are an example of this problem.

Apparent simplification that only pushes cost elsewhere can also be a problem. Removal of a reporting requirement, for example, could prove costly if the information no longer stored or the analysis no longer required is found to be necessary at a later date. In this sense the tax system could have a role in underlining good practice and too much simplification might not be helpful.

Some measure of regressivity is inevitable and compliance costs will always be a problem for the micro-business. It may nevertheless be more efficient for the small business to deal with certain matters of which it has close knowledge than it would be for the revenue services to administer these matters, for example payroll taxes. The market may often come to the rescue here by providing composite services which can be used by the small business sector.

²⁹ The US President's Advisory Panel, above n 25. The recommendations consist of a Simplified Income Tax Plan and an alternative consumption tax plan — the Growth and Investment Tax Plan. The small business implications of these plans are discussed further below.

³⁰ Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1 *eJournal of Tax Research* 64.

³¹ UK Inland Revenue and HM Customs and Excise, *Working Towards a New Relationship: A Consultation on Priorities for Reducing the Administrative Burden of the Tax System in Small Business* (2005); Australian Board of Taxation, above n 17. In the UK, KPMG have created a new tool to model the administrative burden of tax compliance on UK business: *KPMG Administrative Burdens: HMRC Measurement Project*, 20 March 2006; Rachel Anderson, 'Red tape: Measure First, Cut Later', *Tax Journal*, 23 January 2006, 11.

³² Cynthia Coleman and Chris Evans, 'Tax Compliance Issues for Small Business in Australia' in Warren, above n 8.

But there are instances where the compliance costs are a result of unreasonable off-loading of work by the administration where there is no obvious link between the taxpayer's business and the work to be done. In such instances it will make more sense for the revenue to bear the administration costs. This has now been recognised in the UK by, for example, the removal of administration of the Working Tax Credit from employers to the Government, announced in the 2005 Budget. Despite earlier insistence that it was important for this credit to be clearly linked with work through the pay packet, consultation forced the Treasury to remove this burden from small business after just two years.

5 *Proliferation of Size Thresholds*

Unless relief is of a kind that can be made available to all, it needs to be targeted. It may be that different forms of relief will need to be targeted in different ways — it makes sense for a VAT relief to be related to turnover but an income tax relief to be related to profit. However, this will result in a wide variety of thresholds that will leave the business owner confused and possibly also deterred from growth rather than encouraged, since she or he may not wish to cross a threshold and face a jump in tax liability. Coleman and Evans have called for greater definitional consistency where possible as a means of reducing compliance costs.³³ The proliferation of tests has been noted as a characteristic of systems in the US and Australia as well as the UK.³⁴ Wherever possible, thresholds should be harmonised and new thresholds should be considered in the context of existing ones. If there is a need for different thresholds for good reason, the rationale should be clearly considered.

In a report prepared for the Institute of Chartered Accountants in Australia, Warren, Payne and Hodgson argue that small business definitions should be collected into one piece of legislation so that business and their advisors can view all concessions together and that parliamentary attention should be drawn to deviations in definitions so that such definitions would need a clear justification.³⁵ This would be a useful procedural and administrative improvement but, going beyond these terms of reference and into substance, it could be argued that, if a relief is worth giving, serious thought should be given to whether it could be given across the board to all business to prevent a barrier effect. This will not always be appropriate, but where a relief is unlikely to be one that larger businesses will opt for or benefit from, it may do no harm to make it available generally to prevent a sharp cut off line. A non-tax example is the corporate financial audit. Arguably the limit for requiring a mandatory audit could be set quite high because any serious businesses wishing to borrow or transact major business will probably be able to produce an audit report on a voluntary basis anyway. Application of this principle may be more difficult in a tax context but is worth considering in particular instances.

6 *Frequency of Change and the Failure to Understand the Importance of Stability*

All taxpayers desire stability and certainty but it is recognised that there is a trade off between certainty, fairness and responsiveness. Because change is so costly for micro-business due to the learning curve and general regressivity of administrative burdens, successive attempts to improve fairness by fine-tuning may not be appreciated as much as governments expect them to be. Frequency of legislative change has been identified as a prime cause of high compliance costs.³⁶

³³ Ibid.

³⁴ See the separate contributions of Stewart Karlinsky and Garry Payne to Warren, above n 8.

³⁵ Neil Warren, Garry Payne and Helen Hodgson, The Institute of Chartered Accountants in Australia, *Research and Recommendations on the Definition of Small Business* (2006).

³⁶ Evans, above n 30, citing Sue Green, The Institute of Chartered Accountants in England and Wales, *Compliance Costs and Direct Taxation* (1994).

It may be that there are circumstances in which business would prefer to live with a less than perfect provision on the basis that a fairer or more precise provision would be more costly to operate. The costs of change *per se* need to be taken into account in policy making. The temptation to keep inventing new schemes needs to be avoided. The Chartered Institute of Taxation make this clear in their response³⁷ to the 2005 Consultation by the Inland Revenue and Customs and Excise (now HMRC) on the administrative burdens of the tax system on small businesses.³⁸ In response to the question, ‘What might enhance the existing range of VAT simplification schemes available to small businesses?’ they state ‘there are those amongst us who feel that the question posed here is the wrong one. Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.’ Here is a direct example of practitioners on the ground resisting what has been called above complex deregulation or even complex simplification. Previous lobbying has produced a form of Dean’s attractive complexity which consists of an array of small business VAT options, most of which have a low take up rate. Deciding whether to opt for them itself creates cost. For example, the flat rate VAT is used generally only if it will produce a cost lower than using regular VAT accounting, which requires advisers to work the figures for both methods so that there is a compliance cost rather than the intended saving. This comment suggests that these small business advisers at least recognise the downside of adding so-called simplification schemes rather than eliminating choices.

III FALLING INTO THE TRAPS — SOME CASE STUDIES

Recent experience of small business taxation policy in the UK may be used to illustrate a number of the above points. Whilst some of the damage done has recently also been undone, this undoing has itself been potentially costly since it involves change. Other issues remain in doubt and there is a sense of uncertainty. Generally there is not a good relationship between small businesses, especially the micro-business sector, and government due to the series of measures introduced over the past few years.³⁹ Although the number of small business owners is far smaller than the number of employees, the small business owning taxpayer has a strong voice and the expressions of discontent over their tax treatment has been vocal beyond their number.

A Corporation Tax Rates

The prime example of bad policy making for small business in the UK has been the introduction of a zero rate band for incorporated businesses. This illustrates an attempt to stimulate growth through taxation which was not well targeted and which therefore failed. This error also resulted from a failure to understand the way in which the legal form of small business worked. There was a failure to differentiate small and micro-businesses. In addition, the attempts to counter the effects of the failure layered a complex so-called ‘anti-avoidance provision’ over the top of the relief. Even those benefiting from the relief were then involved in cost and complexity. By the time both the relief and the anti-avoidance provisions were abolished in 2006, the small business community was so pleased to see the back of the complexity that there was no outcry at the disappearance of the relief even though it only

³⁷ Chartered Institute of Taxation response to UK IR and HM Customs and Excise report, above n 31.

³⁸ UK IR and HM Customs and Excise, above n 31.

³⁹ There is a great volume of literature on the general subject of discontent in the practitioner journals and also on websites. For examples see Mike Truman and Francesca Lagerberg, ‘Am I bovvered?’ *Taxation*, 8 December 2005; <<http://www.shout99.com/contractors/index.pl?n=10>>. See also Anne Redston, ‘Small Business in the Eye of the Storm’ [2004] *British Tax Review* 566.

brought everyone back to where they were four years previously — indeed it was generally welcomed.⁴⁰

The changes that occurred over the four years from 2002 to 2006 have created expenses for businesses which had incorporated and were now not going to benefit as much as they had previously believed. There can be tax penalties on disincorporation. The pace of change has left small business owners confused and bemused, especially as they have been berated as tax avoiders, whereas as far as most of them were concerned they were simply following their accountants' advice to take up an incentive offered to them by government.

The nil rate was introduced in 2002 and its removal announced in the Pre-Budget Review of December 2005. There is little or no dissent from the view that this was a failed experiment. The introduction of the nil rate in 2002 was followed by behaviour which all taxpayers and their advisers saw as both rational and entirely predictable but which government preferred to consider an 'unforeseen consequence' and a form of tax avoidance. In other words, businesses incorporated to obtain the tax benefit of the zero rate even if they did not intend to grow. In terms of predictability, this seems to fall into the category of red-hot poker burning people. Alice would not have been surprised.

The problem was pointed out by the Institute for Fiscal Studies⁴¹ and others and highlighted in the Standing Committee debates on the 2002 Finance Bill.⁴² Nevertheless the Government persisted with this policy. Speaking in the House of Commons Standing Committee on introducing the measure, the Paymaster General explained the government's thinking: 'The measure recognises that businesses growing beyond a certain size will often be companies. We believe that cutting corporation tax is an effective way of targeting support at small and growing businesses'.⁴³

As discussed above, there is a fallacy in the argument that because the relief was targeted at companies and because companies are more likely to grow than unincorporated firms it would be primarily growing businesses that were targeted. Although the Treasury had, according to the Paymaster General, taken account of the effects of the new relief on behaviour, they do not seem to have understood the flexibility of legal form and the ease with which any business could become a company. Thus, the Paymaster General, presumably briefed by her officials, stated:

Some 78 per cent of businesses are unincorporated despite the fact that there are already theoretical tax benefits for incorporating... There is no shortage of tax advisers seeking to earn a fee from advising companies that that is the best way forward, but we have still not seen that change... We are convinced that the balance is right... Surely small businesses will not look a gift horse in the mouth, We want to create growth and economic activity, and to sustain entrepreneurial activity.⁴⁴

They soon saw the change and small businesses were not slow to respond to the gift horse. The zero rate was introduced for companies with a profit of £10,000 or less. Beyond that, there was a tapering relief for companies with profits up to £50,000 at which point the formula operated to ensure that the entire £50,000 was subject to tax at 19 per cent. The 19 per cent relief remains for companies with profits up to £300,000. For a company with profits

⁴⁰ Indeed, these changes had been proposed by several small business organisations, including the Forum for Private Business, which pointed out that the compliance cost of the anti-avoidance provision outweighed the savings from the nil rate — see the Forum's key recommendations within the Pre-Budget Report, November 2004. See also Alan Southern and James Meyrick, Small Business Research Trust, *Owner-Managed Businesses and Their Tax: An Interim Report on the Views of Small Businesses* (2004), although their results seem equivocal: possibly those questioned were rather confused, or comprised a skewed sample, or both.

⁴¹ Laura Blow et al, Institute of Fiscal Studies, *Budget 2002: Business Taxation Measures* (IFS Briefing Note No 24).

⁴² UK *Parliamentary Debates*, House of Commons Standing Committee F, 16 May 2002.

⁴³ *Ibid* c 114.

⁴⁴ *Ibid* c 115.

between £300,000 and £1.5 million there was (and still is) marginal relief until the full rate of 30 per cent is reached at that level.

Although the £10,000 profit limit was very low it could be achieved in more cases than might be expected through the use of salary payments to family members as well as other deductions. Salaries must be paid 'wholly and exclusively' for the purpose of the trade of the company to be deductible.⁴⁵ This has not, in the past, frequently been the matter of investigation unless payments are exceptional, although this may be changing. Such salaries are, of course, subject to income tax and National Insurance Contributions ('NIC'), but if kept low and paid to family members with no other income who are on low or nil rates of tax, savings can be made. Combined with the fact that, following the abolition of advance corporation tax, dividends carry a tax credit even if paid out of profits which have not been taxed, this was an effective and completely legal tax planning route.

Many very small self-employed taxpayers were advised to incorporate and incorporations rose dramatically. There were 222,000 incorporations in 2001, 293,000 in 2002 and nearly 397,000 in 2003.⁴⁶ The Treasury began to worry. In 2004 it decided that the loss to the Exchequer was too great and that action must be taken. The obvious action would have been to abolish the nil rate but this would have involved loss of face. Therefore the Non-Corporate Distribution Rate ('NCDR') was introduced.⁴⁷ According to the Regulatory Impact Assessment which was used to introduce it, the measure was necessary to 'focus tax incentives for business where they are most effective to support enterprise and growth' and to 'discourage businesses from incorporating solely or mainly for the tax and NIC advantages without changing their economic activity'.⁴⁸

Needless to say, the NCDR rate involved long and complex legislation (six dense pages) relative to what was to be achieved. Effectively, where distributions were paid out of profits taxed at less than 19 per cent the NCDR increased the corporation tax rate to 19 per cent on that amount of the distributed profits thus negating the advantage of the nil rate for the vast majority of micro-firms which make small profits and whose owners need to draw them all in order to live. In the process, legislation was introduced which was described by one commentator as bordering on the surreal.⁴⁹ Once this kind of legislation is introduced, the 'tax planning' mind instantly turns to ways in which it might be avoided and groups of companies might be used, although the amount to be gained would make it hardly worthwhile. Nevertheless legislation was needed since there was an obvious loophole. The compliance costs created by this legislation and the learning curve for advisers was quite disproportionate but the Government response was initially that the tax profession had brought it on itself and its clients by advising the small businesses to incorporate. Not surprisingly in the light of Dawn Primarolo's earlier reference to gift horses, the small business community was not impressed.⁵⁰

It is to the credit of the new team at the Treasury that this rather silly business was cleared up in the 2005 Pre Budget Report proposals, by the simple device of removal of both the nil rate and the NCDR. Although obvious, this must have taken some doing with the politicians,

⁴⁵ Section 34 *Income Tax (Trading and Other Income) Act 2005*; *Copeman v William J Flood & Sons* [1941] 1 KB 202; *Mallalieu v Drummond* [1983] 57 TC 330.

⁴⁶ DTI, *Companies in 2004-5* (2005) Table A4.

⁴⁷ Section 28 and sch 3 of the *Finance Act 2004* (UK) (now s 13AB and sch A2 of the *Income and Corporation Taxes Act 1988* (UK)), noted in Susan Ball, 'The Non-Corporate Distribution Rate — Section 28 and Schedule 3' [2004] *British Tax Review* 459.

⁴⁸ HMRC, *Regulatory Impact Assessment Corporation Tax: The Non-Corporate Distribution Rate* (2004) <<http://www.hmrc.gov.uk/ria/non-corp-dist-rate.pdf>>.

⁴⁹ Ball, above n 47.

⁵⁰ Eg David Rae, 'Small Companies Tricked into Tax Trap', *Accountancy Age*, 20 February 2004.

but there has been relatively little crowing since everyone is so relieved. The Regulatory Impact Assessment,⁵¹ however, has a touch of *Yes Minister* in its language when it states:

This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their businesses.

Gordon Brown, Chancellor of the Exchequer, when announcing this move in his Pre-Budget speech was careful not to repeat the error of suggesting that the small businesses incorporating were themselves tax avoiders but instead cast the stone at their advisers, saying: ‘I am closing a relief under which, for tax reasons only, people are being persuaded without changing what they do to set up a company’.

This is an extraordinary statement from a government which was trying to do the persuading and shows a fundamental misunderstanding of what it means to incorporate, given that it is well established that incorporated and unincorporated businesses may have identical underlying economic activities although in a legal sense people do change ‘what they do’ when they set up a company because they alter their rights and duties.

The Regulatory Impact Assessment acknowledges that the change is a response to requests from the small business community to the Treasury’s earlier paper *Small Companies, the Self-Employed and the Tax System*,⁵² but notes there was no consensus on future developments as a result of the extensive consultation that followed this paper. Thus we are back to square one although the quid pro quo from government for removing the nil rate was to increase first year capital allowances (depreciation) for small businesses from 40 per cent to 50 per cent for investment in plant and machinery made in the year April 2006.

I have dwelt on this example because it is hard to find another that is quite so clear a cautionary tale about the consequences of ignoring good, common sense advice. Do not ignore the significance of legal form or think that incentives can easily be targeted. Companies are no different from unincorporated firms in this unless they wanted to grow in the first place when the company law and commercial advantages (such as the availability of floating charges as a form of finance) may assist them to grow. People will react to tax incentives by changing their behaviour. Most small businesses are micro-businesses and most micro-businesses are not in the business of growing. Bolstering indiscriminate forms of relief with provisions to cut them down creates complexity in the tax system for all and this increases cost and resentment of the tax system.

B Status Issues

The problem of defining self-employment and distinguishing it from employment will be familiar to Australian readers.⁵³ In the UK, the distinction continues to be governed by the old case law.⁵⁴ The incentives to be self-employed are in part tax based as a result of more relaxed rules on deducting expense for the self-employed but the real driver is NIC, where there are significant savings to be made through self-employment.

1 Personal Service Companies

Many micro-businesses provide services rather than goods and the individuals concerned may be hard to distinguish from employees on the traditional tests. Those to whom they

⁵¹ HMRC, *Partial Regulatory Impact Assessment*, above n 11.

⁵² See HM Treasury, above n 11.

⁵³ In Australia the *New Business Tax System (Alienation of Personal Services Income) Act 2000 (Cth)* introduced a definition of ‘personal services income’ into s 84-5 of the *Income Tax Assessment Act 1997 (Cth)* but the case law distinction remains relevant to the interpretation of this provision.

⁵⁴ For a fuller discussion of these issues see Judith Freedman, *Employed or Self-employed? Tax Classification of Workers and the Changing Labour Market* (2001). <http://www.ifs.org.uk/comms/dp1.pdf>

provide their services do not wish to engage in the difficult question of whether they are employees — for tax, employment law and other legal reasons they wish them to be clearly providing only services. As a result they encourage or even require these businesses to incorporate. The person supplying the services is still an employee, of course, but he is an employee of his own personal service company ('PSC'). This opens up opportunities for extracting at least part of the remuneration for the services by way of dividend and so saving on NIC. Income splitting with other family members also becomes possible.

The difficulty here is that whilst some PSC owners are merely disguised employees, others genuinely may be budding entrepreneurs, given the chance, but both types often start off by working only for one client and have some of the common law badges of employment. The government has seen the development of PSCs (which existed well before the nil rate complication described above but was not helped by it) as a form of tax avoidance. From April 2000, special rules for taxing PSCs were imposed.

Once again, this seems to reveal a lack of understanding of the way businesses form and develop. As mentioned, some of these PSCs are nothing but employees seeking to pay less tax but this legal form may encourage even those who start out as essentially employees to start thinking and acting like real entrepreneurs. In any event, the avoidance, if there is such, is not initiated by the workers but by the often larger businesses being serviced in this way. In its original form, this legislation would have imposed a duty on those to whom services were being provided. This might have had a positive social effect in persuading such businesses to revert to straightforward employment, but the superior lobbying power of the businesses soon ensured that responsibility was transferred to the workers. This legislation then made less sense than originally intended but the Government ploughed on with it. Having introduced it, they may have thought that the nil rate for small corporations could safely be introduced because all non-entrepreneurial small businesses would be caught by the PSC legislation. This also reveals misunderstanding, since not all non-growing, micro-businesses have the characteristic that they are disguised employees. The rich pattern of different micro-business types was not recognised.

The rules designed to tax PSCs, known as 'IR 35' after the number of the press release heralding their introduction, have been met with much discontent and litigation.⁵⁵ There was a problem of inequity as between employees and disguised employees to be countered but the broad way in which this has been implemented and the disregard for employment law issues has led to resentment and may mean that workers pay tax as employees but without any of the non-tax benefits. In addition some genuine entrepreneurial activity may be deterred.

The IR 35 legislation⁵⁶ subjects the earnings of PSCs and other entities (such as partnerships) to income tax and NIC as if the individual had earned them. The rules apply where a worker provides his or her services to a client who is a business (not, for example, to householders); the arrangements are made through an intermediary such as a company or partnership; and the worker would have been treated as employee of the client for tax and NICs purposes had the arrangement been made between the worker and the client.

Where these rules apply, the client continues to pay the intermediary gross and salary paid by the intermediary to the worker is subject to the Pay as You Earn and NIC rules in the usual way. But to the extent that the intermediary does not pay out its entire earnings as salary, the intermediary is treated as paying a salary to the worker on the last day of the tax year (or

⁵⁵ See *R (on application of Professional Contractors Group Ltd) v IRC* [2001] STC 629. The Professional Contractors Group is now funding the test case of *Jones v Garnett* [2005] EWCA Civ 1553 (CA) discussed further below: <<http://www.pcg.org.uk/cms/index.php>>.

⁵⁶ Introduced by the *Finance Act 2000* (UK); now *Income Tax (Earnings and Pensions) Act 2003* (UK) part 2, chapter 8. Noted in Judith Freedman, 'Personal Service Companies: The Wrong Kind of Enterprise' [2001] *British Tax Review* 1.

earlier, if relationship with the intermediary ceases before then). In addition, benefits in kind paid to the intermediary are taxed in the same way as employee benefits. Dividend tax relief is given to prevent double taxation, and a deduction is allowed for expenses of running the intermediary equal to 5 per cent of the receipts from the engagements caught by the legislation. Any amounts spent by the intermediary, which could have been claimed as expenses against income tax had the worker been employed by the client and had paid them himself, can be deducted but only under the more restrictive employee deduction rules.

In determining whether the worker would have been an employee of the client had there been a direct relationship between them, the existing case law that seeks to distinguish the employed from the self-employed is used. This case law is fact-based and lacking in clarity, leaving workers and intermediaries in a state of uncertainty.

The IR 35 legislation falls into a number of pitfalls. It makes no attempt to understand the real motivation of the people using PSCs and also fails to relate the use of the corporate form with action in other areas of the law such as employment law. It is complex and uncertain in its operation, which imposes a cost and burden on a greater number of business owners than are ultimately subject to the provisions, because many people need to seek advice. This is a source of a great deal of angst for business people, which causes considerable annoyance beyond those in fact subject to the legislation. It also creates a great deal of work for professional advisers, but work which they would perhaps prefer not to have as it is not especially productive or lucrative. These advisers should not be let off the hook since they have been happy to encourage incorporation for tax reasons and are also active in creating concern about IR 35 in quarters where there is no need to worry about it, but then none of this is surprising or unreasonable. An adviser who had not advised a client to consider incorporation when the nil rate was available would have been negligent.

2 *Income Splitting*

A feature of PSCs is that they facilitate income splitting. The IR 35 legislation prevents this but where the legislation is not applicable income splitting remains possible. In Australia, likewise, there is a problem perceived by the Australian Taxation Office ('ATO') where Divisions 84 to 87 of the *Income Tax Assessment Act 1997 (Cth)*, which limit alienation of personal services income, do not apply. In Australia, it seems that this may be tackled under the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936 (Cth)* (the 'GAAR'), although there may have been a recent retrenchment of this approach following the decision in *Ryan v Commissioner of Taxation*.⁵⁷ In the UK, since we have no GAAR, HMRC has resorted to using anti-avoidance provisions designed for settlements (the 'settlements provisions') and categorically not originally intended for this situation.⁵⁸ This has proved an expensive and confusing experience and the litigation continues in a test case, *Jones v Garnett*, also known by the name of the company as *Arctic Systems*.⁵⁹ A detailed discussion of the settlement provisions analysed in this case is outside the scope of this paper but much has been written and will be written in the future and it raises fundamental issues of principle relating to the micro-business.⁶⁰

⁵⁷ *Ryan v FCT* [2004] ATC 2181; ATO *Taxfacts*, 'General Anti-Avoidance Rules and How They May Apply to a Personal Services Business', March 2003; ATO, 'Refocus of the Income-Splitting Test Case Programme', Announcement 13 December 2005; Taxation Determination TD 2005/29.

⁵⁸ Formerly s 660A of part XV of the *Income and Corporation Taxes Act 1988 (UK)* and now in ch 5 of pt 5 to *Income Tax (Trading and Other Income) Act 2005 (UK)*.

⁵⁹ *Jones v Garnett* [2005] EWCA Civ 1553 (Court of Appeal).

⁶⁰ See Mark Robson, '*Jones v Garnett*: Settlements and All That', [2005] *British Tax Review* 15; Glen Loutzenhiser, '*Jones v Garnett*: High Court Gives Taxpayer the Cold Shoulder' [2005] *British Tax Review* 401; Glen Loutzenhiser, '*Jones v Garnett*: Court of Appeal puts HMRC on ice' [2006] *British Tax Review* 140; HMRC, 'A Guide to the Settlements Legislation for Small Business Advisers'

Briefly, and in a much simplified form, the story is a familiar one. Mr Jones was an Information Technology ('IT') employee made redundant in 1992. He and his wife started an IT consultancy firm. IT agencies would only deal with limited companies so that they and their clients were not bothered with tax and employment law issues, so Mr and Mrs Jones acquired an off-the-shelf company named Arctic Systems and each purchased one of the two issued shares at £1 each. Mr Jones was the company director. Mrs Jones was not a director but was company secretary and handled the administration.

Over four years, Arctic provided Mr Jones' services to three agencies and four clients, one client at a time. He worked full-time for the company but Mrs Jones spent only four to five hours per week on company business. There was some question of IR 35 applying, but the level of activities was just enough to prevent this. Clearly, in a world without tax and employment law there would have been no need for a company. However, that is not the world we live in and there was a genuine company for perfectly rational and legal reasons. These reasons included tax reasons but fiscal motivation alone does not invalidate a transaction for tax purposes.⁶¹ The Joneses knew they were setting up a structure that might result in a tax saving but also, in effect, we can say that Mrs Jones was investing in Mr Jones, just as if the company had owned a painting or a piece of land she would have invested in that.

The turnover of the company was £91,000 and salaries were kept low: Mr Jones was paid only £7,000 pa and Mrs Jones £4,000 pa. This was the area of attack. Mr Jones was clearly being paid less than market value for his work and this allowed profits to be taxed at low company rate and stripped out in the form of dividends with a tax credit and no national insurance to Mr and Mrs Jones who could then both use personal allowances and lower rate tax bands. This was an example of completely standard tax planning.

Although Mr Jones' salary was on the low side, he and others were very surprised to find themselves under attack for current and past years as a result of HMRC claiming that the settlements provisions applied. The Special Commissioners (at first instance), found in favour of HMRC⁶² as did Park J in the High Court.⁶³ The Court of Appeal overturned the lower courts and found in favour of the taxpayer. HMRC are currently seeking leave to appeal to the House of Lords. In essence, the issue was whether there was a 'settlement'. This involved deciding whether there was any element of 'bounty', a judicial gloss put on the meaning of settlement and discussed extensively in the case law.⁶⁴ The statutory definition describes a settlement as an arrangement and much depended on what was included in the arrangement here. The Court of Appeal decided that the arrangement here was the acquisition of a share for which both parties paid full value in the context of a joint business venture to which both would contribute. The governance arrangements under which Mr Jones but not Mrs Jones was a director were also included but this did not necessarily confer a benefit on Mrs Jones. There was no 'bounty' in this set up. Subsequent dividend payments were not part of the initial arrangement. The company would not necessarily make any profit. It would not necessarily pay dividends. It was all unpredictable. As Keene LJ commented: 'It is difficult to regard such a Protean state of affairs as capable of being part of an arrangement in the sense

http://www.hmrc.gov.uk/practitioners/guide_sba.pdf (hereafter the 'HMRC Guide'). A guidance note from professional bodies on self-assessment following the Court of Appeal decision in *Jones v Garnett* may be found in Chartered Institute of Taxation et al, 'A Guidance Note on Disclosure for Self-Assessment for the Year Ended 5 April 2005' (January 2006) <http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_90449>.

⁶¹ *Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1.

⁶² [2005] STC (SCD) 9.

⁶³ [2005] STC 1667.

⁶⁴ *Chinn v Hochstrasser* [1982] AC 533; *IRC v Plummer* [1980] AC 896; *Copeman v Coleman* (1939) 22 TC 594; *Crossland v Hawkins* (1960) 39 TC 493; *Mills v Commissioners of Inland Revenue* (1974) 49 TC 367.

used in the legislation.’⁶⁵ Carnwath LJ, with whom Keene LJ agreed, stated that the purpose of the legislation was not clearly ascertainable and in those circumstances the Revenue’s position seemed to be to argue for an unwarranted extension:

For the first time, they seek to apply the concept to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value. Such a difference, by itself, is not enough to my mind to take the arrangements into the realm of ‘bounty’, as it has been understood in the existing cases. If the legislature wishes such an arrangement to be brought within a special regime for tax purposes, clearer language is necessary to achieve it.⁶⁶

While it is easy to see the mischief being attacked here, the use of the settlements provisions is widely thought to be misconceived. It is a lazy approach to policy making because the problem is perceived as being too hard to tackle with specific and structural legislation. This has created serious uncertainty for many small businesses and a general sense of persecution. The purpose of referring to the case in this paper is to highlight this policy failure rather than to investigate the fine detail of the settlements provisions, although there is an important story to write on this also.

The central feature creating this problem is the ability of micro-businesses to incorporate and thus transform income from labour into income from capital. Within a family context but where the regime is one of independent taxation of spouses, there are many conflicts of policy and practicalities. This is a question that needs addressing in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses in the round. Instead, the government has allowed HMRC to continue to address the issue as a self-contained operational matter. They have attacked a form of doing business which has a long pedigree with anti-avoidance legislation designed for another purpose in the 1930s.

It is arguable that *Jones v Garnett* affects fewer businesses than is being implied by the professional bodies, who claim it could affect 200,000 family businesses. HMRC argue that only 30,000 businesses are at risk and this may be because they may pursue this only in what they consider to be extreme cases (although the case of Mr and Mrs Jones hardly seems extreme).⁶⁷ This is not a sufficient safeguard, however. Small company owners cannot know whether they are at risk since, even after the test case is decided, each case will be decided on its facts. They are required to self-assess and are subject to penalties if they get this wrong. The HMRC Guide runs to 50 pages, with detailed examples but cautions that there may be circumstances in which the interpretation it gives will not apply because cases turn on their own facts.⁶⁸ In effect, the rule that HMRC really want to apply is that set out in their summary at paragraph 6.2 of the Guide:

When considering whether or not the settlements legislation applies it is worth remembering that Parliament introduced the settlements legislation to prevent individuals transferring their income to a relative or friend in order to avoid tax. It therefore follows that a simple test to indicate whether or not the legislation might apply is to consider whether the same arrangements would have been made with a third party at arms length. Take a step back and consider, “If I was making these arrangements with an independent third party would I be paying them these wages or dividends or sharing my partnership profits in this way? If the answer is no then the legislation probably applies.

This looks very like a GAAR. The UK does not have a GAAR and the Court of Appeal has not applied the above test but, rather, one based on the wording of the settlement provisions which HMRC sought to apply.

⁶⁵ *Jones v Garnett* [2005] EWCA Civ 1553, [102] Keene LJ.

⁶⁶ *Ibid* [108]. Carnwath LJ. Other detailed issues arising in the case were whether, if there was a settlement, there was an applicable exception for an outright gift which was not substantially a right to income. This could become important in the House of Lords if it is decided there is a settlement but the comments were obiter. The legislation is obscure with a complex legislative history.

⁶⁷ Figures are taken from the High Court hearing: see Loutzenhiser, above n 60.

⁶⁸ HMRC Guide, above n 60.

On the facts of *Jones v Garnett*, the settlements provisions did not have the effect HMRC are arguing for. But small business owners have little guidance on which to base their self-assessment tax returns due at the end of January 2007, although the professional bodies have done what they can to assist⁶⁹ The result is complexity and uncertainty and a sense that the Government is antagonistic to small business which is precisely the contrary of what government policy set out to be.

It is interesting to note how similar a position seems to have been reached in Australia by the very different route of the GAAR. The ATO comments that in its *Taxfacts* note that:

others may disagree with these views and that concepts of employment, business and entrepreneurship have progressed since the cases from which our views were formed were heard. We are looking to identify test cases to obtain further judicial guidance as to the correctness of our views. We are doing so in consultation with tax professional bodies.⁷⁰

Although the Commissioner has lost the case of *Ryan*, the ATO continues to argue that Part IVA of the ITAA36 may apply in blatant cases, but perhaps not in standard husband and wife partnership cases. In a case where the remuneration of the main service provider was very low, as in *Jones v Garnett*, it is not clear what the ATO views would be.

In neither jurisdiction does this seem to be a good way to create or implement policy for small family businesses. It fails to understand the nature of such businesses and the contribution made by them as well as the importance of tax stability. In the UK, the approach of the government requires the courts to answer impossible questions about the value of a spouse's contribution to the business because the tax system has permitted income from employment to be converted into income from capital. If a person in Mr Jones' position is to be taxed on a minimum deemed salary then this needs to be made clear and the circumstances in which it is to happen must be spelt out. In trying to formulate these circumstances, policy makers would encounter grave difficulties as there is a lack of clarity of objective. They should not expect the courts to be able to solve this problem for them. The current approach falls predictably and firmly into the pitfalls for those making small business policy.

IV THE MORAL OF THE STORY AND LIVING HAPPILY EVER AFTER

As with all cautionary tales, it is easier to deliver dire warnings than to prescribe a course of action, other than staying at home and avoiding all excitement. Perhaps that is the lesson here for governments. The best thing may still be to interfere as little as possible, to keep change limited and to move away from introducing a lot of special schemes which require definition, thresholds and anti-avoidance provisions. Keeping it simple may mean just that: doing nothing.

The tax system for small businesses will only be as good as the system for business generally and, given the drawbacks with profits taxes and the problems of integrating corporate level and shareholder taxes we cannot expect an easy answer for small businesses. The ideal might seem to be to alignment of treatment of all businesses, whatever their legal form, to prevent opportunities for arbitrage, but given the very real differences between businesses at each end of the spectrum this looks less attractive and even less possible when

⁶⁹ Guidance note from professional bodies, above n 60. The case is due to be heard by the House of Lords in mid-2007. HMRC have not altered their Guide in the meantime. They say in *Jones v Garnett: Further Advice* 'We have been granted leave to appeal to the House of Lords, and the Court of Appeal decision cannot therefore be regarded as final. In the circumstances we believe it would be premature to reconsider the guidance and the examples we issued in November 2004 ... The correct time to do that is when the case has been finally resolved. <http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm>

⁷⁰ ATO, above n 57.

examined in detail.⁷¹ The latest major report on tax reform, the US President's Advisory Panel report,⁷² offers a radical proposal for all firms, the Growth and Investment Tax Plan, which is a quasi-consumption tax, or a less radical Simplified Income Tax Plan. The latter would offer cash basis accounting for business under \$1 million annual cash receipts. Small businesses could expense all outlays and would have no other special measures, for example no research and development credit. SMEs, incorporated or not, would use designated bank accounts for all business income and expenditure. The report is a little short on practical detail but it seems that the bank would report direct to the Internal Revenue Service and business would be prohibited from making personal expenditures out of this account. Small firms would be taxed on a pass-through basis regardless of legal form, as most are now in the US, but would also have a choice to be taxed as corporations at a lower rate. It has been suggested that the proposals offer significant potential for tax sheltering.⁷³ Unfortunately, the proposals seem to understand small business very little and the significance of legal form in terms of real legal consequences even less.⁷⁴

There may be administrative changes that can be made to ease the lot of small business in connection with their tax burden but for the most part they want clarity and stability rather than the 'attractive complexity' of a great selection of schemes on which advisers may like to advise them but about which they would sooner not have to worry even if the result is a little more tax. The time of the business owner may be worth more than the tax saving resulting from such schemes. If certain behaviour is seen as undesirable, then revenue authorities need to spell out the circumstances clearly, for small business owners will take advice from tax advisers on tax minimisation quite reasonably and should not have to make fine distinctions dependent on case law to ascertain whether what they are doing will be effective. Governments must remember that small business owners, even if very close to being disguised employees, are legally not employees and do not have their advantages. The small business owner may well see him- or herself as running a small business, encouraged by the rhetoric of governments themselves; if he or she takes risks that the clients will not bear, why is she or he not performing one of the functions of a genuine small business and why should he or she not be able to take the tax advantages the system offers such risk takers?

The message to tax policy makers, therefore, is to examine small businesses, especially micro-businesses in their social and family context. Understand what drives them and that they are not simple. Small business owners have many motivations and targeting tax relief to a whole range of businesses in this way will affect behaviour across the range and not only to enhance entrepreneurship and growth. Do not confuse cause and effect: incorporated businesses may be more likely than unincorporated ones to grow but it does not follow that all incorporated firms wish to grow, especially if there are tax advantages to incorporation without growing. At the same time, recognise that legal form really does make a difference to rights and obligations and therefore to economic substance so that encouraging incorporation should not be done lightly. It is not a popular message but perhaps incorporation should be made harder and not easier. The easy availability of such a form for the small business is not a simplification and perhaps is an attractive complexity.

Finally, in attacking a perceived mischief, policy makers must be clear about the mischief and its underlying causes. If the cause is a distortion in the tax system, do not blame the small

⁷¹ This will be examined in more detail in the small business chapter of the Mirrlees Review (forthcoming, <<http://www.ifs.org.uk/mirrleesreview>>) and see Judith Freedman, 'Small Business Taxation – the indefinable in pursuit of the unachievable?' *Hardman Lecture*, 2006 (Tax Faculty of the Institute of Chartered Accountants in England and Wales, <<http://www.icaew.co.uk/index.cfm?route=105098>>).

⁷² The US President's Advisory Panel, above n 25, chapter 6.

⁷³ George R. Zodrow and Charles E. McLure, Jr., 'Time for US Tax Reform? The Tax Reform Panel's Recommendations' *IBFD Bulletin*, April 2006.

⁷⁴ Daniel Shaviro, 'Blueprint for Future Tax Reform?' (2005) 109 *Tax Notes* 827 questions the practicalities.

business for utilising the distortion. Micro-business owners are not always rational but neither are they entirely irrational. To return to the cautionary tale, if business owners are offered sweets, they will take them, but if they find they are laced with poison they may learn eventually not to take any more sweets.

Sweets need to be handed out with care, to the people who will benefit from them, and they should not contain poison.

SMALL BUSINESS TAX ADVANTAGES — TOWARDS HOLISM WITH A SUGGESTED DEFINITION, TYPOLOGY AND CRITICAL REVIEW

MARK BURTON*

The primary purpose of this paper is to highlight the shortcomings of the Australian government's consideration of small business tax concessions. These shortcomings comprise a failure to recognise the broad range of small business tax advantages which are not expressly legislated tax concessions, and also the failure to undertake a credible tax expenditure review of existing and proposed tax concessions. The paper argues that in the absence of a comprehensive mapping and critical analysis of small business tax advantages, it is not possible to determine whether the considerable public subsidies allocated to small business are justifiable. The paper concludes by arguing for reform of the legislative process which has allowed imperfect appraisal of small business tax advantages to pass unnoticed. In particular, the paper argues that adoption of accepted public administration norms would entail substantial alteration to the current legislative process and also to the current (limited) process of post-implementation review of legislated measures. Closing the information gap with respect to small business taxation would enable rigorous analysis of alternative small business taxation models, including presumptive taxation and would be an important step towards appraisal of government support for small business provided by any level of Australian government and under taxation and/or spending programs.

I INTRODUCTION

Prior to the 2006 Budget extension of small business tax concessions, the *measured* Australian small business tax concessions alone were expected to cost the government \$1.2 billion in the 2006/2007 year.¹ Moreover, in the 2006 Budget the government announced further express small business tax concessions at a projected cost of \$159 million in the 2008/09 income year,² when the full revenue impact of these measures emerges. The measured small business tax expenditures are substantial in both absolute and relative terms.

In 1994, the OECD noted the paucity of information which might inform judgments regarding the relative effectiveness of small business tax concessions.³ The contemporary Australian experience indicates that little has changed, at least in Australia, in the intervening years. Indeed, so poor is the available information regarding the relative effectiveness of these concessions that one must wonder whether the Australian government is the least bit interested in obtaining such information. Given the current Australian government's rhetoric of financial prudence, it is somewhat surprising that measured government expenditure in excess of \$1.35 billion annually

* LLB(Hons)(Tas) PhD (ANU); Senior Lecturer in Law, Law School, University of Canberra.

¹ Commonwealth of Australia, Treasury, *Tax Expenditures Statement 2005* (2005).

² The measures comprise an extension to the small business capital gains concessions under Div 152 of the *Income Tax Assessment Act 1997* ('ITAA97') (\$97 million in 2008-09), an extension to the simplified tax system under Div 328 of the ITAA97 (\$55 million in 2008-09) and extension of the depreciation asset rollover relief under Div 40 of the ITAA97 (\$7 million in 2008-09): Commonwealth of Australia, *Budget 2006-07*, Budget Paper No 2 (2006) Pt 1.

³ OECD, *Taxation and Small Businesses* (1994).

can be allowed to pass with what has hitherto been minimal impartial and credible critical scrutiny as to the effectiveness of this program.

The primary purpose of this paper is to highlight the information gap with respect to the government's consideration of small business tax concessions, with the object of enhancing public scrutiny of those concessions. Such information shortfalls arise for two reasons. First is the concentration upon expressly legislated small business tax concessions,⁴ and second is the failure on the part of government to conduct appropriate analysis of tax policy proposals. To redress these shortcomings, this paper:

- 1 proposes an alternative terminology of 'small business tax advantages' which embraces the many forms of competitive advantage experienced by small business, including express and implied administrative advantages and express and implied substantive advantages;
- 2 offers a typology of small business tax advantages;
- 3 offers a critical review of all express Australian small business tax concessions; and
- 4 suggests a way forward in terms of institutional reforms which will enable credible, critical and open scrutiny of small business tax concessions to occur.

This paper has three parts. The first part sets out a definition of 'small business tax advantage', explains why this alternative discourse is to be preferred to 'small business tax concessions' and considers the difficulty of identifying a benchmark against which small business tax advantages might be identified and quantified. The second part of the paper develops a typology of small business tax advantages and offers a brief critical review of the legislated Australian small business tax concessions. The primary purpose of this second part of the paper is to elaborate upon the contention that the public management of the Australian small business tax concessions has been undermined by poor information and poor public consultation. The third part of the paper sets out generally accepted norms with respect to sound public policy making with the intention of setting a benchmark against which the legislated Australian small business tax concessions might be measured. From this foundation, I suggest improvements to the process by which taxation law is made with a view to enhancing the public policy outcomes in the domain of taxation law more generally, and small business taxation measures in particular.

II RECONSTRUCTING THE DISCOURSE OF SMALL BUSINESS TAXATION — ADOPTING 'SMALL BUSINESS TAXATION ADVANTAGES'

A '*Small Business Tax Advantages*' — A Definition

'Small business tax advantages' are tax incidents which are available to at least some small business taxpayers but which are not available to at least some other categories of tax payers. 'Tax advantages' may be obtained unilaterally by the taxpayer as well as being conceded by an authorised decision maker (Parliament, tax administrator). By contrast, the concept of a 'tax concession' is restricted to a benefit considered, and expressly or impliedly conceded by, the relevant decision maker.

For example, one significant small business tax advantage which arguably is not a 'concession' is the practice of 'skimming' — not entering a proportion of cash receipts in the business

⁴ See, eg, OECD, above n 3, 3, 17ff. As a result of this emphasis upon expressly legislated concessions, the OECD states that the only small business tax incentives are measures with respect to the tax base, the basis of assessment (ie lags in payment) and finally in the tax rate (including tax credits): *ibid* 46.

accounts so that no tax is payable.⁵ Assuming that there is nothing more that the legislature or the Commissioner of Taxation can do in a practical sense⁶ to reduce the scale of this sector of the cash economy, it is difficult to see how this small business tax advantage enjoyed by some proprietors is a ‘concession’. Nevertheless, it is an advantage enjoyed by some small businesses by comparison to other taxpayers.

Small business proprietors might also avail themselves of tax advantages which are available to other groups of taxpayers. Such advantages should nevertheless be taken into account in developing a holistic picture of the taxation treatment of small businesses. For example, many small businesses are conducted through an entity which facilitates income splitting. From a tax policy perspective, income splitting will be benign where it merely enables the allocation of income according to the respective inputs of the income recipients, as in the ‘ordinary’ case of dividends paid by a public company in respect of ordinary shares. Such income splitting is benign because the contribution to the business on the part of each income recipient is at least approximately commensurate with the income received. However, in many small businesses no such relativity will exist. Moreover, such incommensurate income splitting is not available to other groups of taxpayers such as sole traders and wage/salary earners, although it is available to yet other groups of taxpayers such as those deriving income from property. The fact that this form of income splitting is available to many small business taxpayers — and not to other groups of taxpayers — supports the proposition that it should be recognised as an advantage available to small businesses. This is the case notwithstanding that the ability to income split is not restricted to small businesses.

Small business tax advantages include:

- 1 criminal tax advantages, such as the practice of skimming referred to above, which are possible within some categories of small business;
- 2 administrative concessions to small business with respect to the administration of the taxation law;
- 3 administrative concessions to small business with respect to the substantive interpretation of the law;
- 4 general express substantive tax concessions allowed to taxpayers, including (some) small businesses. An example here is landcare expenditure;
- 5 specific express substantive tax concessions allowed only to small businesses; and
- 6 implied or tacitly accepted substantive tax concessions which are available to small businesses, such as income splitting.

⁵ Coleman and Evans suggest that ‘many’ surveyed small business proprietors indicated that this may amount to as much as 30 per cent of turnover: Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003). Given the understandable reluctance of survey participants to admit to such criminal tax evasion, one wonders whether survey participants under-report such activity.

⁶ Note the constraint upon the Commissioner’s general administrative discretion imposed by s 44 of the *Financial Management and Accountability Act 1997* (Cth). Also note that the Australian National Audit Office recently provided a broadly favourable report regarding the Australian Taxation Office (‘ATO’) ‘management’ of the cash economy: Australian National Audit Office, *The ATO’s Strategies to Address the Cash Economy*, Report No 30 (2006).

B *Why Change the Discourse to One of Small Business Tax Advantages?*

1 *Towards Better Public Policy*

Adopting a discourse of ‘small business tax advantages’ will re-orient the discussion of small business taxation towards a holistic appraisal of the relative competitiveness of small business. In this way the consideration of small business taxation might be better informed, with a view to procuring better tax policy.

To date, the literature in the field of small business taxation has generally focused upon the provision of express legislative tax ‘concessions’, conceded by Parliament and targeted at small business. The usual justifications for these small business tax concessions are:

- 1 compensating small business for regressive tax/regulatory compliance costs;⁷
- 2 neutrality;⁸
- 3 promoting entrepreneurial endeavour;⁹
- 4 reducing small business taxes;¹⁰ and
- 5 achieving macroeconomic objectives, such as securing economic stability. The small business sector may generate externalities such as countercyclical growth (by comparison to other sectors of the economy) and/or being a source of economic growth which does not merely mirror general economic growth.¹¹

In broad terms, these justifications reflect a desire to enhance the relative competitive position of small businesses, with the object of overcoming competitive disadvantage arising from government regulation/market failure, or merely with a view to advancing small business in a competitive marketplace. The perception that small business suffers from severe competitive disadvantages has been promoted by small business lobby groups by various means such as sponsoring funded research,¹² undertaking surveys,¹³ publishing reports¹⁴ and making submissions to government.¹⁵ These lobbyists emphasise the competitive disadvantages of small businesses by comparison to other taxpayer groups,¹⁶ and ignore or downplay the competitive tax

⁷ For studies regarding such costs see C Evans et al, *A Report into Taxpayer Costs of Compliance* (1997); Binh Tran-Nam and John Glover, ‘Tax Reform in Australia: Impacts of Tax Compliance Costs on Small Business’ (2002) 5 *Journal of Australian Taxation* 338. For discussion of the literature in relation to small business tax compliance costs see: Mark Burton, ‘The Australian Small Business Tax Concessions — Public Choice, Public Interest or Public Folly?’ (2006) 21 *Australian Tax Forum* 91, [2.1.2].

⁸ Commonwealth of Australia, *A Question of Balance — The Tax Treatment of Small Business*, Final report of the Senate Economics References Committee (1995); Commonwealth of Australia, *A Platform for Consultation* (1998) 300.

⁹ C Evans and A Ryan, *Tax Reform Issues for Small Business*, Submission of the Australian Society of Certified Practising Accountants to the Commonwealth Review of Taxation (1999) 12 <<http://www.rbt.treasury.gov.au>>.

¹⁰ See, eg, the Explanatory Memorandum accompanying the *New Business Tax System (Simplified Tax System) Bill 2000* (Cth) [1.7].

¹¹ OECD, above n 3, 99.

¹² See, for example, Tran-Nam and Glover, above n 7 (research funded in part by the National Farmers Federation).

¹³ CPA Australia, *Small Business Survey — Compliance Burden* (2003).

¹⁴ See, eg, Business Council of Australia, *Business Regulation Action Plan for Future Prosperity* (2005).

¹⁵ See, for example, Institute of Chartered Accountants, *2006-2007 Pre-Budget Submission* (2006); CPA Australia, *Pre-Budget Submission 2006-07* (2005).

¹⁶ Note that the OECD observes that such competitive disadvantage would not necessarily warrant government intervention if small businesses only competed against small businesses. However, as small businesses compete

advantages of small business. Thus, for example, much is made of the regressivity of small business tax compliance costs,¹⁷ but no mention is made of the myriad ways by which small businesses minimise their tax payments. Focusing upon expressly legislated ‘small business tax concessions’, rather than the broader range of small business tax advantages, creates a biased discourse of small business taxation. The result is that a lop-sided depiction of small business taxation — one of significant competitive disadvantage — has, apparently, been accepted uncritically by legislators.

‘Small business tax advantages’ is more appropriate nomenclature if we adopt the principle of neutrality which underpins the discourse of small business tax concessions. The principle of neutrality suggests that we should seek to holistically identify and quantify *all* relative competitive advantages/disadvantages which small businesses enjoy/suffer as a result of the operation of Australia’s Commonwealth taxation laws. Only after this is done will it be possible to undertake an analysis of the net effect of Australia’s taxation, and perhaps other,¹⁸ laws upon various categories of small business. In this way a more informed debate may take place with respect to the quantum and nature of small business tax concessions. For example, by the time one has taken into account the benefits of specific express substantive tax concessions and implied/tacitly accepted substantive tax concessions such as income splitting, it might be the case that the ‘excessive’ compliance costs over and above some normative compliance cost threshold might already be overcompensated for. If so, a *reduction* in the scale of small business tax advantages might be warranted.

2 Pragmatic Tax System Design

There are good pragmatic reasons for ensuring that a holistic approach is taken to quantifying small business tax advantages. The proliferation and growth of such advantages without credible and transparent justification may serve to fuel widespread scepticism regarding the fairness of the taxation system on the part of taxpayers who do not benefit from such largesse.¹⁹ As perceived legitimacy is critical to maintaining and enhancing voluntary tax compliance,²⁰ ensuring that small business tax advantages are subjected to credible and critical scrutiny is essential if the tax system is to be protected from the criticism that it works to the advantage of political elites.²¹ If such criticism were widely perceived as justified, Australia might revisit the dark days of the 1970s, when declining public confidence in the taxation system and cynicism regarding the rule of law threatened the integrity of the Australian taxation system.²²

against larger businesses and also against businesses in other jurisdictions, the imposition of disproportionate compliance costs upon small business does warrant closer consideration: OECD, above n 3, 111.

¹⁷ CPA Australia, *Submission to the Board of Taxation regarding Small Business Tax Compliance Costs* (2006).

¹⁸ Julie Roin, ‘Truth in Government: Beyond the Tax Expenditure Budget’ (2003) 54 *Hastings Law Journal* 603.

¹⁹ Michael Wenzel, ‘Tax Compliance and the Psychology of Justice: Mapping the Field’ in Valerie Braithwaite (ed), *Taxing Democracy* (2003) 41, 51-2.

²⁰ Valerie Braithwaite, *Perceptions of Who’s Not Paying Their Fair Share*, Working Paper No 54, Centre for Tax System Integrity (2004); T R Tyler, *Why People Obey Laws* (1990); T Makkai and J Braithwaite, ‘Procedural Justice and Regulatory Compliance’ (1996) 20 *Law and Human Behaviour* 83.

²¹ Thus, in response to the proposition that ‘the Tax Office listens to powerful interest groups more than to ordinary Australians’ and on a scale of 1 (strongly disagree) to 5 (strongly agree), 1143 survey respondents returned a mean of 3.52 with a standard deviation of 1.04: Valerie Braithwaite, *The Australian Tax System: Fair or Not Survey*, Centre for Tax System Integrity (2002) Item 4.1.7. It is possible that the reference to the ‘Tax Office’ was interpreted by respondents to mean ‘the government’ more generally, including the Treasury, Ministers, etc.

²² Margaret Levi, *Of Rule and Revenue* (1988).

C ‘Small Business Tax Advantage’ — Defining the Benchmark

In the past, the discourse of ‘small business tax concessions’ meant that the criterion used to determine whether a tax rule was a small business tax concession was simply whether it was expressly identified as such by the legislature. However, discussion of ‘small business tax advantages’ begs the question of how the benchmark is to be defined such that the existence of an advantage might be ascertained.

As noted above, the discourse of small business tax advantage focuses upon the relative advantage of small businesses. However, in identifying and measuring such advantages one must identify the benchmark against which such advantage is to be measured. This will inevitably engender debate because of the heterogeneity of small businesses and also because the absence of a coherent framework of principles underlying the Australian taxation legislation means that there is no obvious benchmark. In this regard the definition of an appropriate benchmark is akin to the problem of defining the income tax benchmark for the purposes of identifying ‘tax expenditures’.²³

The definition of a benchmark might entail the adoption of:

- 1 a universal normative benchmark such as the ‘benchmark taxation system’ founded upon normative principles such as horizontal equity and neutrality;²⁴
- 2 a relative normative benchmark tax system, which is founded upon the principles which purportedly underpin the particular tax legislation as a whole;²⁵ or
- 3 a flexible benchmark which does not identify one ‘ideal’ tax treatment of the taxpayer but rather examines whether the taxpayer is treated (dis)advantageously by comparison to any other taxpayer or group of taxpayers who are in some sense comparable.

The problem of choosing an appropriate benchmark from this list can be illustrated by addressing the question of whether the income of a small business company should be attributed to its shareholders. In the context of closely held business entities, common within the small business sector, retention of corporate income will be significant because of the differential between the top and second highest marginal personal rates of tax and the corporate tax rate.²⁶ Given the tax rate differential between personal income over \$75,000 and corporate income, there is clearly an incentive for closely held entities to retain profits in the corporate form with a view to investing the corporate after-tax profits in assets (which may or may not be actively used in the course of business). Recognising closely held small business companies as separate entities therefore opens up the opportunity for income alienation and sheltering, with the free *use* of corporate assets (acquired with profits taxed at the lower corporate rate) by shareholders left untaxed.²⁷ Such tax planning advantages are not recognised as ‘small business tax concessions’.

²³ Louis Eisenstein, *The Ideologies of Taxation* (1961).

²⁴ Commonwealth, Treasury, *A Strong Foundation* (1998).

²⁵ Commonwealth, above n 1, ch 4.

²⁶ Currently the top personal marginal rate of tax is 45 per cent (applicable to taxable income in excess of \$150,000, the next personal marginal tax rate of 40 per cent applies to taxable income in excess of \$75,000. A Medicare levy of 1.5 per cent applies on top of these rates of tax. Tax upon corporate taxable income is imposed at the flat rate of 30 per cent: *Income Tax Rates Act 1986* (Cth).

²⁷ Had the unified entities regime been introduced this form of tax planning would have been eliminated, given the proposed definition of ‘distribution’: Commonwealth of Australia, Treasury, *A Tax System Redesigned* (1999) 429ff. The suggestion that a robust Div 7A of the *Income Tax Assessment Act 1936* (Cth) (‘ITAA36’) and Fringe Benefits Tax rules are sufficient to counteract this form of tax planning must be read with some caution: see C Evans and A Ryan, *Tax Reform Issues for Small Business*, Submission of Australian Society of Certified

For present purposes, then, the question is whether such tax planning gives rise to a ‘small business tax advantage’, the total benefit of which should be added to the list of small business tax advantages allowed to small business by the government.

In answering this question there are three possibilities, drawn from the different approaches to benchmark definition outlined above.

First, attribution of profits to the shareholders of the company could be required on the basis of the ‘transparency principle’. It is a bold person who argues that there are universal taxation norms, but nevertheless it is fair to say that the attribution of corporate profits to a company’s proprietors generally is consistent with the principle of horizontal equity — assessing to tax each natural person’s net increase in economic income over a period entails inclusion of the increase in a shareholder’s wealth attributable to their share of increased corporate wealth.

However, the adoption of such a universal attribution rule is beset with practical difficulty²⁸ and also engenders pragmatic shortcomings in terms of fiscal outcomes for Australia. A general attribution rule has therefore not been seriously considered for eighty years or more.²⁹ Nevertheless, in limited circumstances such an accruals rule has been adopted within the Australian taxation legislation.³⁰ Moreover, in the past, an attribution rule known as the sufficient distribution requirement³¹ meant that the capacity to alienate income within closely held companies was limited. However, even if such a rule were adopted in the context of closely held small business companies, it would allow some income splitting in the case of a personal services company by virtue of the allocation of corporate profits across the shareholders.

An alternative approach to application of the principle of horizontal equity dictates that a substance approach should be adopted by recognising that the source of at least some of a company’s profits may be a natural person who exercises actual control of the company. On this approach, that person should be assessed to tax with respect to the income of ‘the company’. Thus, the Australian income tax includes rules which ignore the corporate veil in those circumstances which might loosely be defined as ‘tax avoidance’ arrangements. This substance oriented approach has been adopted, albeit somewhat meekly, with respect to ‘personal services income’.³² Under these rules some ‘personal service entities’, including companies, are required to attribute the bulk of their ‘personal services income’ to the natural person ‘behind’ the company who generates at least the bulk of that income.

However, there are difficulties in applying this substance rule, particularly where at least some of the income is attributable to a source other than the provision of personal services. For example, in the case of a provider of services who obtains financial support from an associate,

Practising Accountants to Commonwealth Review of Taxation (1999) 14 <<http://www.rbt.treasury.gov.au>>. For an interesting account of the political economy of the failure of the proposed unified entities regime see Brett Freudenberg, ‘Entity Taxation: The Inconsistency between Stated Policy and Actual Application’ (2005) 1 *Journal of the Australasian Tax Teachers Association* 458.

²⁸ Commonwealth, *Second Report of the Royal Commission on Taxation*, Parl Paper No 1 (1922) 80-8; Commonwealth, *First Report of the Royal Commission on Taxation*, Parl Paper No 199 (1933) 7-18; Commonwealth, *Report on Taxation of Income of Companies — Private and Non-Private and of Shareholders*, Parl Paper No 143 (1952); Commonwealth, above n 109, 13-19.

²⁹ Commonwealth, Treasury, *A Tax System Redesigned* (1999) 429ff; see also Commonwealth, *Taxation Review Committee — Full Report*, Parl Paper No 136 (1975) ch 17.

³⁰ *ITAA36* Part X (the attribution of some ‘controlled foreign income’ within a ‘controlled foreign company’).

³¹ *ITAA36* Div 7.

³² *ITAA97* Part 2-42. Note also that the general anti-avoidance rules in *ITAA36* Part IVA may apply in those cases where personal services income is not attributed to a natural person under Part 2-42.

who is to say exactly what proportion of the services income is attributable to the ‘finance’ as opposed to the services provided by the service provider? And what of the different levels of risk assumed under different structures? How much of the services income should be considered to be a premium for exposing corporate assets to risk? In his recent statement the Commissioner officially recognised this problem, at least with respect to partnerships.³³ There is no reason why the same problem might not exist in other factual scenarios, such as a corporate personal services entity which obtains finance secured by a guarantee provided by the company’s shareholders. Such vagaries of the substance approach have meant that a general substance rule has limited practical application because it embroils tax administrators in what are ultimately subjective, case by case decisions. In an era of managerial accountability,³⁴ tax administrators will often decide that the cost/benefit calculus dictates that such individualised application of the taxation law is not worth pursuing.

Like a general attribution rule, a general substance rule is theoretically appealing but its subjective application means that it is not an optimal benchmark against which to assess relative tax (dis)advantage.

The second option is to recognise the legal form of the structure and therefore allow retention of profits in the company. On its face, this approach would seem to be consistent with the recognition of the separate entity status of companies for the purposes of the Australian income tax.³⁵ This approach would therefore allow the alienation of any income, whether of a small business or otherwise, within the corporate form.

However, as noted above, the Australian taxation legislation does not uniformly recognise the corporate veil. Constructing a benchmark upon the proposition that the Australian income tax legislation adopts a uniform treatment of the corporate form — the relative normative benchmark — is therefore not possible. The alienation of income within the corporate form therefore does not fall within a relative normative benchmark.

A third option is to compare the tax treatment of small business incorporated entities with other comparable entities, with a view to ascertaining whether small business entities are treated in such a manner that they experience relative (dis)advantage.

In applying this variable benchmark, there are two problematic issues:

- 1 the heterogeneity of small businesses means that multiple categories of taxpayers might comprise benchmarks against which relative advantage is identified; and
- 2 the variability of the benchmark is neutral as to the appropriate level of tax, as it would equally support a ‘ratcheting up’ or a ‘ratcheting down’ of the tax base. However, with respect to small business tax concessions there has been a tendency for the variable benchmark to be applied in a ‘ratcheting down’ manner, such that we see a drive to the bottom in tax base erosion.³⁶

To illustrate the first problem, and depending upon the definition of ‘small business’ adopted, an incorporated consultancy business may range from one conducted by a sole

³³ Commissioner of Taxation, ‘Draft Guidance on Service Arrangements’ (Press Release, 29 June 2005) <<http://www.ato.gov.au/corporate/content.asp?doc=/content/60980.htm>>.

³⁴ See *Financial Management and Accountability Act 1997* (Cth); Anuphan Kitnitchiva, ‘Accountability and Fairness in Tax Administrations — A Case Study of the Thailand Revenue Department’ (2006) *Asia-Pacific Tax Bulletin* 76.

³⁵ Commonwealth, above n 1, 24.

³⁶ See, eg, the application of the neutrality principle in justifying the extension of small business capital gains concessions: Burton, above n 7, [2.1.4].

shareholder/employee to one with a substantial number of employees and also a substantial number of shareholders. At the sole shareholder end of this spectrum, and taking the example of an incorporated consultancy business, one comparable or benchmark taxpayer would be a wage/salary earner because:

- 1 both are utilising their effort/skill to generate income;
- 2 application of the employee benchmark also would be consistent with what is effectively a full attribution regime applicable generally to partnerships and trusts and also with the taxation of sole traders; and
- 3 although the consultant will often assume greater risk than an employee, the consultant's income should incorporate a risk premium which can be retained if services are performed with sufficient skill so as to minimise their risk. Thus, in a sense, the derivation of income will be attributable to the provision of personal services and therefore be analogous to the wage or salary earner.

However, a second comparable or benchmark taxpayer might be an incorporated entity in which the shares are widely held and/or the services are conducted by a number of employees. Both the sole shareholder personal services company and the widely held personal services company are engaged in similar activity and, issues of scale aside, would often have similar commercial constraints such as the need to maintain/expand goodwill. Both types of personal service entity might quite justifiably wish to retain after tax profits for reinvestment for commercial purposes. Given that the income tax system recognises the separate entity status of companies (as detailed in the discussion of the second, 'formalist', option for defining the benchmark above), allowing the alienation of profits within a widely held entity while not allowing a similar facility to a closely held entity would create competitive advantage in favour of widely held entities in those cases where closely held and widely held entities are actually (rather than hypothetically) competing in the same market.³⁷ This would suggest that alienation of income within the corporate form is not a tax advantage, at least in those cases where income is retained for the purpose of business investment.

However, in other cases closely held entities will retain profits for non-commercial purposes such as the purchase of unproductive private assets as detailed above. Such tax effective income alienation is less likely to arise in the case of widely held entities. In such cases, allowing the alienation of profits within the corporate form is clearly a tax advantage, as it effectively allows 'the shareholder' to purchase private assets from income which has been taxed at the lower corporate tax rate.

The preceding discussion suggests that a relative benchmark is more appropriately referred to in the plural form — in many cases there will be more than one benchmark. In such cases according priority to a particular relative benchmark will be subjectively grounded.

This review of various benchmarks against which small business tax advantages might be identified and measured suggests that all of these benchmark definitions suffer from some theoretical and/or practical limitations. Given that there is no one benchmark which wins universal support, the selection of a benchmark will be influenced by an individual's subjective perspective. For example, some will be attracted to the apparent objectivity of the 'theoretically pure' first definition of a benchmark while others will prefer the 'practical' assessment of the realpolitik of tax law apparent in the latter two definitions. However, given that the recent discourse of small business tax concessions has relied upon the third, floating benchmark, for the

³⁷ OECD, above n 3.

purposes of the next part of this paper I am prepared to adopt a benchmark grounded upon the neutrality principle as outline in #3 above. In doing so, I am not necessarily adopting this discourse but am prepared to adopt it for the simple reason that small business advocates can hardly challenge this paper for adopting the discourse which they have embraced. Nevertheless, if pressed, in my view it would be preferable if a benchmark framed broadly upon normative principles, as outlined in part 1 above, were adopted.

III A TYPOLOGY AND CRITICAL REVIEW OF AUSTRALIAN SMALL BUSINESS TAX ADVANTAGES

The literature regarding small business tax concessions generally focuses upon the category I have called specific express substantive tax concessions — those express tax concessions which are targeted at some or all small businesses. One of the key purposes of offering this typology of small business tax concessions is to illustrate the range of small business tax advantages which have hitherto been ignored in the tax policy literature.

A *Criminal Tax Advantages*

As noted above, the ability of some small businesses to evade taxation constitutes a small business tax advantage, when compared to the employee/medium enterprise norm. Although the literature on this matter is somewhat sparse, it does indicate that small businesses form the preponderant part of ‘hard to tax’ taxpayers engaged in the cash economy.³⁸ Further, it seems that the risk of participation in the cash economy diminishes as the enterprise increases in size and employs more staff.³⁹

The extent of criminal underpayment of tax is difficult to quantify, however the work of Coleman and Evans,⁴⁰ and also anecdotal evidence received by the author, indicates that a significant number of businesses do not declare as much as 30 per cent of gross income. Such a tax advantage is clearly significant, and both legislative and administrative strategies need to be employed to address this threat to tax system integrity. For example, the merits of a presumptive tax regime applicable to small businesses should be examined, with a view to determining whether a double dividend of reduced tax compliance costs and enhanced voluntary tax compliance might be obtained.⁴¹

³⁸ Australian National Audit Office, *The ATO’s Strategies to Address the Cash Economy*, Report No 30, 2005-06 (2006) [1.15]; David Giles and Lindsay Tedds, Canadian Tax Foundation, *Taxes and the Canadian Underground Economy* (2002) 36. See also James Alm, Jorge Martinez-Vazquez and Friedrich Schneider, “Sizing” the Problem of the Hard to Tax’ in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds), *Taxing the Hard to Tax* (2004) 11, 13.

³⁹ David Giles, ‘Modelling the Tax Compliance Profiles of New Zealand Firms: Evidence from Audit Records’ in Gerald Scully and Patrick Caragata (eds), *Taxation and the Limits of Government* (2000) 243.

⁴⁰ Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 153-4.

⁴¹ See Victor Thuronyi, ‘Presumptive Taxation of the Hard-To-Tax’ in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds), *Taxing the Hard to Tax* (2004) 101; OECD, above n 3, 50 (discussion of ‘forfaitaire’ arrangements by which a flat rate of tax is applied to a simplified tax base (ie gross turnover less certain expenses)).

B *Administrative Concessions Regarding the Operation of Administrative Provisions*

In some instances small businesses have received the benefit of considerable administrative lenience. For example, the Inspector-General of Taxation last year reported that the ATO had been lenient in not enforcing the tax debts of a substantial number of small businesses.⁴² Although the General Interest Charge ('GIC') is applicable to such debts, and that interest rate is greater than the interest rate with respect to secured debt, the GIC rate is less than interest charged with respect to unsecured finance such as credit card debt. Moreover, the GIC is tax deductible,⁴³ whereas interest with respect to credit card debt will not be deductible if the debt has arisen with respect to personal expenditure. It is little wonder, then, that small business proprietors will prefer to defer payment of tax debts.

Applying the benchmark of 'competitive advantage' in this context would entail consideration of whether the ATO has been more lenient with respect to small business operators by comparison to other categories of taxpayers. Again, taking employees as the benchmark, the Pay-As-You-Go withholding regime as applied to wage or salary payments means that employees generally do not have the opportunity of delaying payment of their tax obligations in order to pay down personal debt which carries a greater, non-deductible interest burden.

C *Administrative Concessions with respect to Operation of Substantive Rules*

Although the Commissioner might be criticised for adopting a partial, pro-revenue interpretation of the taxation law,⁴⁴ there are also instances where the Commissioner appears to have adopted an interpretation of the law which is unduly favourable to small businesses. For example, in his recent statement with respect to personal services income,⁴⁵ the Commissioner stated that he considered that 'in the usual case' a partnership could not derive personal services income because of the assumption of risk by the partners. This proposition applied, the Commissioner added, even where the partnership income was in a sense solely attributable to the performance of services by one of the partners.

This conclusion is open to doubt for a number of reasons:

- 1 the personal services income rules themselves acknowledge that a partnership can derive personal services income, without any apparent restriction of this proposition to 'unusual cases';⁴⁶
- 2 the associated extrinsic materials also clearly accepted that the personal services income rules might apply to partnerships;⁴⁷ and
- 3 the Commissioner's rationale is that the assumption of risk by the partners means that the income is earned, not by the partner providing the personal services, but rather

⁴² Commonwealth of Australia, Inspector-General of Taxation, *Review into the Tax Office's Small Business Debt Collection Practices* (2005).

⁴³ *ITAA97* s 25-5.

⁴⁴ See, eg, Gordon Cooper's analysis of the Commissioner's recent Taxation Ruling TR 2006/2 with respect to professional service entities: Gordon Cooper, 'Service Entities' (2006) 40 *Taxation in Australia* 592.

⁴⁵ Commissioner of Taxation, 'Refocus of the Income-Splitting Test Case Program' (2005) <<http://www.ato.gov.au/corporate/content.asp?doc=/content/67313.htm>>.

⁴⁶ See, eg, *ITAA97* s 86-10.

⁴⁷ See, eg, the Explanatory Memorandum accompanying *Alienation of Personal Services Income Act 2000* (Cth) [1.1].

predominantly with respect to the assumption of risk by each of the partners.⁴⁸ As the assumption of risk does not entail exercise of personal effort or skill, the argument continues, Pt 2-42 cannot apply to this income.

However, although it is true that a partner's income will compensate a partner for the risks that they assume, it is doubtful that the assumption of risk will be the predominant source of partnership income. Section 84-5 of the *ITAA97* defines personal services income as income which is 'mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income)'. Therefore it would be possible for a partnership to receive personal services income notwithstanding that some part of the partnership income is attributable to the assumption of risk by the partners. This will be the case provided that the income with respect to the assumption of risk, combined with income from assets used in deriving income, does not form the preponderant part of the partnership income.

Given the express legislative acknowledgement that the personal services income rules might apply to partnerships and the opacity of the Commissioner's unconvincing reasoning in apparently concluding that a service partnership will derive the preponderant part of its income with respect to the assumption of partnership risks, it is difficult to conclude that the Commissioner's statement is anything but an administrative concession with respect to the operation of the substantive law in relation to a significant number of small businesses.⁴⁹

D *Legislative Concessions with Respect to Tax Administration*

There are also a range of express administrative concessions allowed to small businesses, including the annual turnover registration threshold for the purposes of the goods and services tax,⁵⁰ modified remittance rules with respect to tax payments,⁵¹ modified record keeping obligations,⁵² and modified tax return filing obligations.⁵³ Such provisions are expressly allowed competitive advantages which focus upon small business. However, the benefit of such concessions generally is not recognised, largely because they do not fall within the concept of a tax expenditure adopted by Australian Treasury.⁵⁴ To the extent that such concessions reduce the tax compliance costs borne by small business, and assuming accurate compliance cost measurement, these concessions will be accounted for because they will reduce the compliance costs otherwise borne by small business. However, some express administrative concessions will not necessarily reduce tax compliance costs. Thus, a rule which merely defers the date for lodgement of a tax return and simultaneous payment of tax does not reduce the tax compliance workload, but it may constitute, in effect, the provision of an interest free loan by the government to small business.

⁴⁸ Michael D'Ascenzo, 'Along the Road to Damascus: A Framework for Interpreting the Tax Law' (2000) 3 *Journal of Australian Taxation* 384.

⁴⁹ For the 2004/05 income year there were 370,725 'micro' partnerships, being partnerships with 'total business income' (which may be gross income or taxable income) of at least \$1 but less than \$2 million: Australian Taxation Office, *Taxation Statistics 2003-04* (2006) 74.

⁵⁰ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) div 23.

⁵¹ *Tax Administration Act 1953* (Cth) s 45-140.

⁵² *ITAA97* subdiv 328-E.

⁵³ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) div 31.

⁵⁴ Commonwealth of Australia, Treasury, *Tax Expenditures Statement* (2005) ch 4.

E Legislative Concessions with Respect to Substantive Rules

There is a range of substantive ‘small business tax concessions’, advantages with respect to the substantive operation of the tax law which are expressly allowed by Parliament and which target some or all small businesses.

1 Simplified Tax System

The *Tax Expenditures Statement 2005* states that the Simplified Tax System (‘STS’) in Division 328 of the *ITAA97* is expected to cost \$200 million in the 2006/2007 year.⁵⁵ This figure will have to be revised upwards in light of the Budget 2006 extension of the STS system to include businesses with an annual turnover of up to \$2 million.

Div 328 allows qualifying small businesses to:

- 1 pool depreciating assets and write off the value of the pool at accelerated rates of depreciation;⁵⁶
- 2 account on a receipts basis of accounting;⁵⁷ and
- 3 escape trading stock accounting where the difference between the value of trading stock at the start of the income year and the end of the income year is reasonably estimated to be \$5000 or less.⁵⁸

(a) Stated Purpose

These provisions were proposed on the basis that they would reduce small business tax compliance costs,⁵⁹ while the government added the objective of lowering small business taxation when the measures were introduced into Parliament.⁶⁰

(b) Evidence Based Justification?

The Committee undertaking the Review of Business Taxation did not undertake an analysis of the particular sources of the small business tax compliance burden⁶¹ and nor, it seems, has such an analysis been undertaken since the introduction of these measures. Further, neither the Committee nor Treasury modelled the impact of the STS system with a view to determining whether or not the STS benefits flowed to those businesses which incurred tax compliance costs which are at the higher end of the scale.

Such an analysis would need to identify:

- 1 the profile of small businesses which bore the brunt of tax compliance costs. The limited evidence on this point indicates that some industries bear higher compliance costs, while costs increase also as the business encounters more taxes with which it must comply;⁶²

⁵⁵ Commonwealth of Australia, Treasury, *Tax Expenditures Statement* (2005) 94, item B51.

⁵⁶ *ITAA97* subdiv 328-D.

⁵⁷ *ITAA97* subdiv 328-C.

⁵⁸ *ITAA97* subdiv 328-E.

⁵⁹ Commonwealth Treasury, *A Tax System Redesigned*, above n 8, 575ff.

⁶⁰ Explanatory Memorandum accompanying the *New Business Tax System (Simplified Tax System) Act 2000* [1.7]; although note that the Regulation Impact Statement only referred to the reduction in compliance costs: Explanatory Memorandum [8.7].

⁶¹ For a discussion of the outcomes of the A New Tax System and Review of Business Taxation reforms in terms of small business compliance costs see: Michael Dirkis and Brett Bondfield, ‘The RBT ANTS Bite: Small Business the First Casualty’ (2004) 19 *Australian Tax Forum* 107.

⁶² Marsden Jacob Associates and Brian Sweeney and Associates, Small Business Deregulation Taskforce, *Working Overtime: A National Survey of the Paperwork Burden on Small Business*, Background Paper 3 (1996) 23.

- 2 the type of business which encounters particular forms of compliance costs. For example, 'lifestyle' small businesses might incur additional compliance costs in arranging for the proprietor/employee to take some business 'profits' in the form of concessionally treated fringe benefits rather than in the form of fully assessable income. By contrast, a growing small business might need to attract good staff by offering a competitive remuneration package which includes concessionally taxed fringe benefits. Perhaps ideally the STS measures would benefit the latter business while excluding the former, assuming that the underlying purpose of small business tax concessions is to foster entrepreneurship;
- 3 the types of entity which bear higher compliance costs. For example, given the advantages of conducting a business through a discretionary trust, such additional compliance costs should only be recognised for tax policy purposes if the tax advantages are also weighed in the tax policy calculus;
- 4 the types of transactions which attract higher compliance costs; and
- 5 the managerial benefits which emerge from incurring tax compliance costs.⁶³

(c) *Targeting*

A review of the extrinsic literature regarding the STS leaves the reader guessing as to just what compliance costs were targeted with this tax expenditure, the extent of those compliance costs and the extent to which the tax expenditure was intended to counteract those costs.⁶⁴ For example, offering tax concessions in the form of accelerated depreciation and/or trading stock accounting concessions⁶⁵ will be of little benefit to small business employers if prohibitive compliance costs are associated with employing additional staff. While accelerated depreciation might be beneficial, Dirkis and Bondfield have noted the compliance costs associated with accessing such concessions.⁶⁶

The poor targeting of these rules in their original form is reflected in the relatively low uptake of the measures. When introducing the STS legislation the government boasted that a substantial majority of the 1 million eligible businesses were expected to elect into the STS.⁶⁷ However, to date the response has been less than impressive⁶⁸ with a take up of just 20 per cent of eligible

⁶³ Philip Lignier, 'A Silver Lining in the Tax Compliance Cost Cloud? A Study of the Managerial Benefits of Tax Compliance in Small Business' (Paper delivered at the 7th International Tax Administration Conference, Crown Plaza Resort, Coogee, Sydney, 21 April 2006).

⁶⁴ P Kenny, 'A Simplified Tax System for Small Business: Or, Just Another Tax Preference?' (2002) 6 *Taxation Specialist* 36; Brett Bondfield, 'If There is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 *Australian Tax Forum* 313.

⁶⁵ As currently allowed under div 328 of the *ITAA97*.

⁶⁶ Dirkis and Bondfield, above n 61, 147ff; Bondfield, above n 64, 327ff.

⁶⁷ Explanatory Memorandum accompanying the *New Business Tax System (Simplified Tax System) Act 2000* (Cth) [1.6]. In the Second Reading Speech of the *New Business Tax System (Simplified Tax System) Act 2000* (Cth) the Minister for Financial Services and Regulation observed: 'The government considers that the consultations with small business representatives have been a very positive and important part of the development of the simplified tax system. I would like to thank those involved in that extensive process for their efforts.' See also Peter Costello, Treasurer, 'Simplified Tax System: Release of Exposure Draft Legislation' (Press Release, 26 October 2000).

⁶⁸ See, eg, Sue Prestney, 'Fessing up about STS' (2003) 74 *CA Charter* 40; Mark Fenton-Jones, 'Push for Simpler Tax Mode', *Australian Financial Review* (Sydney), 29 June 2004; 'Diminishing Attractions of STS', *Manly Daily* (Sydney), 9 April 2003; CPA Australia, *Small Business Survey — Compliance Burden* (2003) 16. Such reports confirm the anecdotal evidence offered by some accountants to the author that they advise their clients

businesses.⁶⁹ The government's bullish claim that the take up rate had 'met projections'⁷⁰ must be questioned. More recently, the government amended the operation of the STS by enacting the *Tax Laws Amendment (2004 Measures No 7) Act 2005*. The Explanatory Memorandum to the Bill merely noted that:

For many small businesses the cash accounting requirement is not appropriate for their business or financial circumstances. The requirement to use this method has been seen as a restriction which has prohibited many small businesses from accessing the benefits of the STS. The removal of this restriction will permit more businesses, including many in the farming sector, to take advantage of the concessions associated with the STS. The removal of the cash accounting requirement will enable more businesses to access the benefits of the STS whilst calculating their taxable income using the most appropriate method applicable to their circumstances.⁷¹

It might be observed that this amendment suggests that the government is less concerned with the nexus between compliance costs and tax concessions and more concerned with allowing qualifying small businesses substantial tax concessions by allowing them to cherry pick the most advantageous tax accounting rules.

(d) *Compliance costs?*

The Regulation Impact Statement accompanying the original STS legislation made vague references to 'some' upfront compliance costs,⁷² while suggesting that ongoing compliance costs would be reduced as a result of these measures.⁷³ No specific data was referred to, and nor has there been any subsequent public study focusing upon STS compliance costs.

2 *Division 152*

Division 152 of the *ITAA97* incorporates rules which allow concessional treatment of capital gains emerging from CGT Events with respect to 'active assets' of qualifying small businesses. The concessions comprise:

- 1) Complete exclusion from assessable income with respect to gains:
 - a) emerging from active assets, provided that the relevant active asset(s) have been held for more than 15 years; and
 - b) the CGT Event which gave rise to the gain happens in connection with the retirement of a business proprietor who is 55 or over at the time of the CGT Event or where the proprietor is permanently incapacitated at the time of the CGT Event;⁷⁴
- 2) if #1 does not apply, a further 50 per cent discount with respect to capital gains, in addition to the general 50 per cent discount which will be allowable with respect to active assets held for more than 12 months;⁷⁵

not to bother with STS because the benefits are generally marginal at best. See also R Brass, 'The Simplified Tax System — Are There Any Winners?' (2002) 15 *Taxpayer* 227.

⁶⁹ CPA, above n 68, 16: the source for this statement is not provided by the CPA; see also Australian Tax Practice, 'Simplified Tax System (STS): 14 per cent Take-Up Rate So Far', *ATP Latest Tax News* (No 163, 25 August 2003).

⁷⁰ John Howard, *Promoting an Enterprise Culture*, Election policy of the Coalition Government (2004) 3.

⁷¹ Explanatory Memorandum accompanying the *Tax Laws Amendment (2004 Measures No 7) Act 2005* (Cth). See also John Howard, *Promoting an Enterprise Culture*, Election policy of the Coalition Government (2004) 3.

⁷² See, eg, Explanatory Memorandum accompanying the *New Business Tax System (Simplified Tax System) Bill 2001* (Cth) [8.17].

⁷³ *Ibid* [8.19].

⁷⁴ *ITAA97* s 152-105.

⁷⁵ *ITAA97* s 152-205.

- 3) after allowing for the general capital gains discount and the concession allowed under section 152-205, any remaining active asset gains rolled over into a superannuation fund by a small business proprietor who is less than 55 at the time the capital proceeds are received will be exempt from taxation in the hands of the proprietor (but will be assessable income in the hands of the superannuation fund). A lifetime limit of \$500,000 applies to this exemption;⁷⁶ and
- 4) after allowing for the general capital gains discount and the concessions allowed under ss 152-205 and 152-305, a gain emerging from a CGT Event with respect to an active asset will be rolled over if the business proprietor acquires a replacement active asset within one year before and two years after the relevant CGT Event. If the replacement asset is subsequently disposed of, the key cost base elements of the original asset will apply for the purposes of calculating the capital gain emerging from the replacement asset.⁷⁷

To qualify for these concessions, the following threshold conditions must be satisfied:

- 1 the net value of CGT assets of the business must not exceed \$6 million;
- 2 the CGT Event must arise with respect to an 'active asset' of the small business; and
- 3 if the asset is a share or an interest in a trust, there must be a controlling individual just before the CGT Event and the entity claiming the concession must be a 'CGT concession stakeholder' (the controlling individual or their spouse) in the company or the trust.⁷⁸

The small business tax concessions allowed under Div 152 of the *ITAA97* are estimated to cost \$624 million for the 2006/2007 income year.⁷⁹ This figure may need to be revised upwards in light of the Budget 2006-07 announcement that STS businesses will automatically qualify for Div 152 concessions.⁸⁰

(a) *Stated Purpose*

The extrinsic materials accompanying the bill which inserted Div 152 into the *ITAA97* and also later amendments indicate that the purposes of Div 152 are:

- 1 to promote small business investment;⁸¹
- 2 to enhance the retirement savings of small business proprietors;⁸² and
- 3 to lower the compliance costs of pre-existing small business capital gains concessions.⁸³

The Board of Taxation's post implementation review of these provisions more boldly states that Div 152 'gives effect to the overall policy to provide significant relief from the CGT system for

⁷⁶ *ITAA97* s 152-305.

⁷⁷ *ITAA97* subdiv 112-C.

⁷⁸ *ITAA97* subdiv 152-A.

⁷⁹ Commonwealth, above n 1, 115 (items C6, C7), 140 (items E13, E14).

⁸⁰ Commonwealth of Australia, Treasury, *Budget 2005-06*, Budget Paper No 2 (2006) 31.

⁸¹ *ITAA97* s 152-1; Peter Costello, Treasurer, 'Small Business and Primary Producers to Benefit from the New Business Tax System' (Press Release No 058, 21 September 1999).

⁸² Peter Costello, Treasurer, 'Small Business and Primary Producers to Benefit from the New Business Tax System' (Press Release No 058, 21 September 1999).

⁸³ Paragraph 4.9 of the Regulation Impact Statement accompanying the *New Business Tax System (Capital Gains Tax) Act 1999* (Cth).

eligible small business entities.’⁸⁴ The difference in the perceived purpose of Div 152 reflected in these official statements may be significant. By restricting the perceived purpose effectively to tax reduction, rather than the provision of a tax reduction to promote small business growth and investment, the Board of Taxation obviated the need to consider how the benefit of these concessions was applied by small business taxpayers. Thus, for example, the Board did not see fit to consider whether Div 152 actually does ‘promote small business investment’.

(b) Target Group, and Those Implicitly/Explicitly Excluded

Given the definition of ‘active asset’, the primary ‘active assets’ of a small business will be goodwill and any real property used in the course of carrying on the business. Depreciating assets, including intellectual property, are specifically excluded from the capital gains provisions and so gains made upon such assets will not attract the Div 152 concessions. Many small businesses will not hold significant appreciating active assets — more than two thirds operate from the home of the business proprietor and many will hold insignificant goodwill. Nevertheless, Treasury estimates of the cost of these tax expenditures indicate that those businesses which do hold appreciating active assets obtain a substantial benefit from these concessions. For the 2002-2003 year, the Board of Taxation found that approximately 20,000 small businesses used Div 152.⁸⁵ Unfortunately, a breakdown of such businesses by industry sector and size of enterprise indicia (ie number of employees, turnover, gross assets held) and growth phase (ie whether the business is mature or developing) is not publicly available.

(c) Evidence Based Justification?

As Freedman notes, if there are to be small business tax concessions it would make sense for them to be targeted at entrepreneurial small businesses which are growing.⁸⁶ Further, it would make sense for the concessions to be of most benefit to those who use them to reinvest in their business (rather than taking them for consumption expenditure). In this way, the government would maximise the macroeconomic growth return on its investment. With these objectives in mind the evidence necessary to mount a justification of the Div 152 concessions would include:

- 1 data with respect to the extent to which the concessions influence small business investment decisions; and
- 2 information with respect to the principal beneficiaries of the concessions and the uses to which the benefit of the concessions is put by those beneficiaries.

Unfortunately, in the absence of publicly available data as to the beneficiaries of these capital gains concessions, and the use to which the benefit of the concessions is put, it is impossible to assess the merits of the concessions. Presumably, if such data existed, it would have been referred to in the original explanatory memorandum or in subsequent explanatory memoranda accompanying amendments to Div 152. However, no such data has been referred to.

(d) Compliance costs?

The Explanatory Memorandum accompanying the Div 152 measures indicated that compliance costs associated with access to the small business capital gains measures would be reduced. No data was tendered in support of this claim, and nor was baseline data regarding the compliance

⁸⁴ Commonwealth of Australia, The Board of Taxation, *A Post-Implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Concessions in Division 152 of the Income Tax Assessment Act 1997* (2005) 8.

⁸⁵ Ibid 145.

⁸⁶ Judith Freedman, ‘Small Business Taxation: Policy Issues and the UK’ in Warren, above n 5, 15.

costs associated with the former rules available. In other words, the claim in the Regulation Impact Statement was not verifiable. However, it seems that Div 152 has actually increased the compliance costs borne by taxpayers, and that these compliance costs are substantial in absolute terms.⁸⁷

3 *Entrepreneurs' Tax Offset*

This measure in Div 61 of the *ITAA97* provides qualifying STS taxpayers with a tax offset of up to 25 per cent of their tax liability for a particular income year. STS taxpayers with an STS turnover of less than \$50,000 will qualify for the full offset. If STS turnover exceeds \$50,000 the offset phases out on a straightline basis until STS turnover reaches \$75,000.

The Regulation Impact Statement with respect to this measure indicates that it is expected to cost \$125 million per year. However, the *Tax Expenditures Statement 2005* estimates that the offset will cost \$380 million in the 2006/07 income year.⁸⁸

(a) *Stated Purpose*

The Explanatory Memorandum accompanying the entrepreneurs' tax offset legislation stated:

The objectives of this measure are to provide encouragement for enterprising Australians in the early days of a small business, in particular to provide a greater benefit to businesses with greater productivity, and to provide incentive for the growth of small business especially the very small, micro and home-based businesses which are in the STS.⁸⁹

(b) *Target group, and those explicitly/implicitly excluded*

The explanatory memorandum accompanying this measure does not explain why:

- 1 it is dependent upon the relevant entity having a turnover of less than \$75,000 rather than net STS income being the qualifying condition. Focusing upon gross turnover will exclude many high volume/low margin businesses while those with a high turnover/expenses ratio, such as those in the service sector, will benefit most;
- 2 the offset is only relevant if a qualifying business is profitable, such that taxation is payable by the relevant entity. Many entrepreneurial small businesses do not generate profits in the start-up phase and do not survive. Those small business taxpayers who are only marginally profitable will obtain a miniscule benefit from this measure, if at all. The combined effect of the zero rated threshold and low income rebate mean that no tax is payable until taxable income exceeds \$10,000.⁹⁰ By contrast, this measure will be of most benefit to those earning high income from other sources (ie wage/salary) and carrying on a small business part time. For these taxpayers, there will be substantial tax savings;
- 3 the offset applies equally to entrepreneurial small businesses as well as non-entrepreneurial small businesses; and
- 4 where the relevant STS entity is a company, this tax preference is washed out if the low taxed profits are distributed to shareholders. By contrast, there is no such washout with respect to STS partnerships and trusts.

⁸⁷ Commonwealth, above n 84, 175.

⁸⁸ Commonwealth, above n 1, 82, item B23.

⁸⁹ Explanatory memorandum accompanying the *Tax Laws Amendment (2004 Measures No 7) Act 2005* (Cth) [1.41].

⁹⁰ Commonwealth of Australia, Treasury, *Budget 2006-07*, Budget Paper No 2.

(c) Evidence Based Justification?

If this measure is intended to promote start-up entrepreneurial activity, it would be necessary to consider a range of questions, including:

- 1 the types of entrepreneurial activity which the government wishes to promote. For example, does the government wish to encourage home-based retail businesses such as Amway distributors, or does it wish to focus its limited tax expenditure resources upon enterprises in the 'dynamic' services and technological sectors?
- 2 whether the imposition of income tax upon the profits of entrepreneurial activities constitutes an actual/perceived barrier to entry into those entrepreneurial activities. Further, whether the imposition of income tax upon the entrepreneurs' profits constitutes an actual/perceived impediment to expansion of the entrepreneurial activity. It is possible, for example, that entrepreneurial activities have accumulated tax losses which soak up profits in the first years that the activity turns a cash profit, and that, by the time the losses have been absorbed, the relevant business exceeds the upper gross turnover threshold such that the offset is never available to many expanding entrepreneurial enterprises. Further, it is possible that the slight reduction in tax received at the enterprise level is of only marginal benefit to growing businesses which might have limited income in the first year and income in excess of the maximum income threshold in subsequent years; and
- 3 whether the provision of \$125 million might be better spent. For example, by expanding small business support services or by providing finance guarantees with respect to private sector finance or by expanding the venture capital tax incentives.

The Explanatory Memorandum does not refer to any tax expenditure analysis undertaken with respect to the entrepreneurs' offset, and nor does it attempt such an analysis by referring to relevant data. It seems that no such analysis has been undertaken.

(d) Compliance Costs Associated with Accessing the Concession

The Explanatory Memorandum accompanying the entrepreneurs' offset bill stated that 'this measure is expected to have minimal impact on compliance costs'. No attempt at quantifying these compliance costs appears to have been made. As discussed above in the context of the small business capital gains concessions, it is possible that these compliance costs are substantial in absolute terms.⁹¹

4 Indirect Express Small Business Advantages

There are some other legislated indirect small business advantages such as tax expenditures with respect to venture capital investments.⁹² To the extent that such tax advantages are passed through to 'small businesses', for example in the form of cheaper capital than would otherwise be available, such benefits comprise a small business tax advantage.

5 General Express Concessions Which Benefit Small Business

There are also a number of taxation expenditures which are of general application but which may be of benefit to small businesses. Thus, for example, the capital gains discount will apply

⁹¹ See 'Compliance Costs' above.

⁹² For recent reviews of the operation of such tax expenditures in the Australian context see Miranda Stewart, 'Venture Capital Tax Reform in Australia and New Zealand' (2005) 11 *New Zealand Journal of Taxation Law and Policy* 216; Stephen Barkoczy and John Glover, *Venture Capital Tax Expenditure Programs* (unpublished as at 4 July 2006).

with respect to small businesses' active assets, allowing a small business entity to reduce any capital gain by 50 per cent with respect to an asset held for more than 12 months. Given that s 152-205 allows a further 25 per cent discount of the capital gain, and that this is estimated to cost \$300 million for the 2006/7 income year, the allowance of the general discount with respect to small businesses' active assets presumably would cost twice as much as the s 152-205 concession. Thus, capital gains concessions with respect to small businesses' active assets will cost up to a total of \$900 million for the 2006/7 income year.

There is some difficulty in including all of this \$600 million expenditure under the category of 'small business tax advantages'. The \$600 million figure is derived from the calculation of the expenditure under s 152-205 with respect to small businesses' active assets, and the two primary categories of active business assets are real property and goodwill (given the exclusion of depreciating assets from the capital gains rules). The difficulty of treating all of the \$600 million as a small business tax advantage arises because the benchmark taxpayer, for example a wage/salary earner, may also access the general capital gains discount by investing in appreciating assets. Thus, while a small business proprietor may invest in real property which is an active asset, so may the wage or salary earner also invest in appreciating real property. Thus, to the extent that the derived figure of \$600 million is attributable to active assets which are real property, that proportion should be excluded (on the assumption that the small business proprietor would have made a similar investment in appreciating property even if they were not carrying on a small business). However, the second principle category of active assets is goodwill, which may consist of acquired goodwill and/or self-generated goodwill. The treatment of acquired goodwill is no different to appreciating real assets — both small business proprietors and wage/salary earners may invest in a business which holds appreciating goodwill. However, to the extent that the \$600 million figure is based upon self generated goodwill, that amount is a concession which is not available to a wage or salary earner. Self generated goodwill arises from the exertion of the business proprietor (and quite possibly the business employees) — the capital gain received with respect to such goodwill is in a sense a payment for the exertions/managerial skill of the business proprietor. By contrast, a wage or salary earner is paid fully taxed income for their personal exertions. Thus, that part of the \$600 million figure which is attributable to self generated goodwill, is a small business taxation advantage.

Other tax concessions are of a more general nature but nevertheless either expressly or impliedly apply to small businesses. For example, the limitations upon the prepayment rule which include an express modified operation of the rule with respect to STS taxpayers might be considered to fall within this category.⁹³ An example of an express, general tax expenditure which impliedly benefits many small businesses is the income averaging rules applicable to primary producers.⁹⁴ This tax expenditure clearly benefits all primary producers, but nevertheless should be taken into account when quantifying small business tax advantages because income averaging is not available to other categories of taxpayers such as employees (who may experience fluctuating incomes owing to unemployment, performance based pay mechanisms or other causes).

The relative benchmark definition is also apt in the context of exclusions from the operation of specific anti-avoidance rules inserted into the tax law which are designed to counteract some forms of tax minimization which would otherwise be open to small businesses. For example, Div 7A of the *ITAA36* contains provisions designed to prevent closely held 'private' companies from

⁹³ *ITAA36* s 82KZM.

⁹⁴ *ITAA97* div 392.

effectively distributing corporate profits in an untaxed form, such as by way of interest free loans. However, Div 7A will not apply where a private company allows a shareholder to use a company asset (ie a beach house) free of charge.⁹⁵ Nor will Div 7A apply to an interest free loan which is repaid by the specified time,⁹⁶ with the company shortly thereafter making a fresh loan which is less than and not 'similar to' the amount of the payment (which would usually equate to the amount of the original loan).⁹⁷ Should such a limitation embodied in the legislation be classified as a small business tax concession/relief/advantage? On one view, describing such a rule as a 'limitation' or an 'exclusion' is inappropriate because the rule might be described as a part of the definition of the proscribed 'tax avoidance' conduct rather than an exclusion from the anti-avoidance rule. However, this approach misunderstands the nature of the foundation of the benchmark upon the principle of competitive neutrality. Allowing a shareholder the free use of sheltered income which had been taxed at a rate lower than the shareholder's marginal rate is a tax advantage which is not available to wage or salary earners. The principle of neutrality would suggest, therefore, that such free use of corporate assets should be classified as a tax advantage. The semantic question of whether the legislature has chosen to allow such advantages by creating a circumscribed anti-avoidance rule or by carving out exclusions from the relevant anti-avoidance rule is irrelevant.

F *Implicit Substantive Tax Advantages*

There are also small business tax advantages which arise implicitly as a result of the operation or exploitation of the general taxation provisions. Income splitting is perhaps the primary example of such small business taxation advantages.

Income splitting is commonly used by small businesses where those businesses are conducted through partnerships, companies or trusts. A discretionary trading trust offers considerable flexibility with respect to the admission of new family members into the business structure, streaming of particular categories of income to particular beneficiaries, income sheltering within a company (which might lend the money back to the trust to enable the trust to acquire assets which the 'proprietors' use free of charge, and without any taxation consequences), pass-through of business tax preferences such as accelerated depreciation, flexibility of distribution amounts with respect to particular beneficiaries as well as the ability of being able to employ the 'proprietors' in order to provide them with concessionally treated fringe benefits. A typical structure would allow for splitting of business income between a domestic couple and a family company (to access the lower corporate tax rate, with the company acquiring assets and allowing family members to use those assets without tax consequences). Dependent adult children, who fall outside of Div 6AA of the *ITAA36* by virtue of their age, add to the pool of family members to whom income may be alienated.

To illustrate the tax savings that such a structure might achieve, it is worthwhile taking the situation of a small business which generates a 'profit'⁹⁸ of \$150,000 and comparing the tax paid by a wage and salary earner on that sum to illustrate what might be achieved in terms of tax savings.

⁹⁵ See n 27 above.

⁹⁶ *ITAA36* s 109D(1)(b).

⁹⁷ *ITAA36* s 109R(2).

⁹⁸ That is, excluding any salary or other benefits to the 'proprietors' of the business, who will control the trust through a corporate beneficiary.

Obviously the quantum of the tax advantage which such a structure offers will depend upon a number of variables — the number of adult family members, the quantum of the business income, etc. However, the point is that substantial tax savings may be achieved with little additional compliance costs. Such tax relief has, as far as I am aware, never been referred to in the course of discussing small business tax concessions.

IV TOWARDS BETTER TAX SYSTEM DESIGN

The preceding discussion of small business tax advantages indicates that, to date, the Australian Treasury has not undertaken critical analysis of small business tax concessions by, for example, considering the competitive advantages which benefit small business. If such critical analysis has been undertaken, that analysis has not been made public. If we are to have a government which truly is committed to transparency,⁹⁹ the release of information regarding the existence of such information is highly desirable. In this section of the paper I will outline what such a critical review of small business tax concessions should entail.

A International Norms of Public Policy Making

The United Kingdom government has adopted a statement of nine principles of public policy-making, which hold that good public policy is:

- 1 forward looking;
- 2 outward looking;
- 3 innovative, flexible and creative;
- 4 evidence-based;
- 5 inclusive;
- 6 'joined up', or holistic;
- 7 subject to ongoing review
- 8 subject to built in evaluation; and
- 9 built upon learning lessons from the past.¹⁰⁰

To similar effect, the OECD specified ten guiding principles for promoting the active engagement of citizens in public policy making. These principles include:

- 1 commitment to active engagement on the part of those ultimately responsible for public policy;
- 2 broad rights of the citizenry to access information, provide feedback, be consulted and actively participate in policy making;
- 3 information provided to the citizenry should be objective, complete and accessible;
- 4 mechanisms for promoting active engagement on the part of the citizenry should be adequately resourced;
- 5 there must be appropriate feedback provided to those engaged in the consultation process;
- 6 governments should adopt measures which build the capacity of citizens to actively engage in the process of shaping public policy.¹⁰¹

⁹⁹ Commonwealth of Australia, *Making Transparency Transparent* (1999).

¹⁰⁰ Helen Bullock, Juliet Mountford and Rebecca Stanley, Centre for Management and Policy Studies (a branch of the UK Cabinet Office), *Better Policy-Making* (2001) 14.

Other examples of policies which promote active engagement in public policy formation on the part of the citizenry are readily identified.¹⁰² The broad proposition which emerges from these policies is that public policy formation is no longer generally conceived in terms of a top-down, hierarchical or inside-out manner.¹⁰³ Rather, public policy formation is widely perceived as a process in which a well informed citizenry is equipped with the skills, and given ample opportunity, to actively engage in public policy formation. Of course, such democratic processes do not entail abdication from public accountability on the part of those charged with government — democratically elected governments must remain ultimately responsible for the legislative outcomes. However, the concept of accountability means that citizens must be adequately informed so as to be in a position to hold governments accountable. As such, democratic participation should enhance transparency and accountability, while also promoting better public policy.

B *What Would These Norms Mean for Taxation Expenditures?*

In the context of taxation expenditures such as small business tax concessions, these norms would mean that:

- 1 sufficient, appropriate and credible information is available to policy makers, including the general public, at the commencement of the policy design process. In particular, information regarding the net (dis)advantage of small business by comparison to a defined benchmark would be critical to an informed discussion of public policy in the domain of small business taxation. This would entail compliance with items 1, 2, 4, 6 and 9 in the preceding list of public policy norms;
- 2 broad consultation would be undertaken with respect to the decision to utilise tax expenditures and also with respect to the design of those expenditures. This would entail compliance with item 5 in the preceding list;
- 3 careful consideration be given to whether competitive disadvantages experienced by small business might more efficiently be overcome by means such as tax system reform or regulatory reform rather than by tax expenditures. This would entail compliance with items 3 and 6 in the preceding list;
- 4 on-going review of any tax concessions resulting from this process be implemented, and this review to entail consideration of the validity of the policy underpinning the legislation as well as the effectiveness of the legislation in achieving the stated policy; and
- 5 the entire process of considering small business tax concessions would be subject to evaluation.

C *Are These Norms Adopted in Australia?*

The Regulation Impact Statements applicable to taxation legislation have failed to adopt these norms. The preceding discussion of express substantive small business tax advantages suggests

¹⁰¹ OECD, *Citizens as Partners* (2001) 15.

¹⁰² See, eg, European Commission, *The Commission's Contribution to the Period of Reflection and Beyond: Plan-D for Democracy, Dialogue and Debate*, COM(2005) 494 final (2005); European Commission, *European Governance: White Paper*, COM(2001) 428 final (2001); European Commission, *Towards a Reinforced Culture of Consultation and Dialogue — General Principles and Minimum Standards for Consultation of Interested Parties by the Commission*, COM(2002) 704 final (2002).

¹⁰³ OECD, above n 101.

that the process by which the Australian small business tax concessions are created and maintained is critically flawed. There are substantial shortcomings with respect to the information upon which those measures are based, the process by which the community is engaged in developing these measures and also the nature and process by which the measures are reviewed and evaluated after their introduction. In particular:

- 1 the purpose of these measures is expressed in vague and/or unverifiable terms, such as ‘lowering small business taxation’, ‘promoting small business entrepreneurship’ or ‘lowering compliance costs’ (without any data regarding the baseline compliance costs being available). The failure to identify key strategic outcomes when introducing these measures is reflected in the poor targeting of the measures. For example, these measures do not differentiate ‘lifestyle’ businesses — businesses which the proprietor has little/no intention to expand — from entrepreneurial small businesses which may truly be an engine room for economic and jobs growth;
- 2 little or no effort is expended in identifying existing systemic tax advantages available to small business ie income splitting, income sheltering;
- 3 despite the scale of this tax expenditure program, it is characterised by an absence of any convincing evidence justifying the introduction of small business tax concessions and of the particular form of small business tax concessions;
- 4 similarly, there has been apparently no effort to examine small business tax advantages in other jurisdictions;
- 5 the procedures adopted in introducing these measures exhibit an ad hoc and non-inclusive approach to consultation with the wider community, while small business lobbyists appear to gain special access to government. For example, with respect to the entrepreneur tax offset measures it is clear that the government consulted intensively with the small business sector, without apparently engaging in wider consultation with respect to the merits of these measures;
- 6 there is an absence of a whole of tax system approach, as no study has been undertaken with respect to small business tax advantages provided by all levels of government;
- 7 there is an absence of a whole of government approach as no study has been undertaken with respect to small business advantages provided across all government programs (spending, regulatory and taxation) and across all levels of government;
- 8 when introducing small business tax concessions, little regard is paid to the cost of overlaying another layer of tax complexity upon an already complex tax system, despite the government’s rhetoric to the contrary. For example, the cost of accessing the small business capital gains concessions is considerable and may be greater than the cost of ‘complying’ with similar antecedent provisions, despite the fact that the government indicated that a purpose of the new provisions was to lower compliance costs;¹⁰⁴ and
- 9 no credible justification has been provided for why tax expenditures should be preferred to outright spending programs. The small business sector as a group might pride itself on its self-reliance, and so might spurn direct government assistance. To overcome this problem, governments might provide subsidies through the tax system which are not perceived as ‘welfare’. However, the literature regarding small business tax expenditures makes no reference to this. More cynically, it might be that the tax expenditure welfare is hidden from

¹⁰⁴ Commonwealth, above n 84.

public scrutiny, making it more difficult for commentators to point the finger of hypocrisy at small business advocates who simultaneously advocate small business welfare while promoting the neo-liberal ideology of self reliance to the broader population.

When one considers the parlous state of Australian tax policy design reflected in the Australian small business tax concessions, the justifications put forward in *A Guide to Regulation* for not engaging in comprehensive critical review of tax policy measures¹⁰⁵ seem particularly flimsy. At no point in the legislative process are the Australian small business tax concessions subjected to a credible process of open and transparent critical scrutiny and public consultation. Moreover, the conduct of post implementation reviews by the Board of Taxation does little to redress the problem of the absence of critical review of proposed tax legislation. The Board of Taxation interprets that part of its Charter which states that it will advise the Treasurer ‘on the quality and effectiveness of tax legislation’ in a quite limited fashion. Rather than taking the opportunity to conduct a broad ‘tax expenditure analysis’ akin to that envisaged by Surrey,¹⁰⁶ the Board restricts the scope of its post implementation reviews by merely examining the technical aspects of legislation, viz the extent to which the legislation:

- 1 gives effect to the government’s policy intent;
- 2 is expressed in a clear, simple, comprehensible and workable manner;
- 3 avoids unintended consequences of a substantive nature;
- 4 takes account of actual taxpayer circumstances and commercial practices;
- 5 is consistent with other tax legislation; and
- 6 provides certainty.¹⁰⁷

Most importantly, the merits of the Government’s policy are not open to question during the course of a post implementation review.¹⁰⁸

D *The Need for Further Research*

The Australian government does not systematically follow norms of good governance with respect to public policy making in formulating its tax legislation, and in particular in formulating its small business tax concessions. The preceding discussion of the Australian small business tax concessions suggests that such norms should be followed, and in particular those concessions should be subjected to a rigorous, transparent and open tax expenditure analysis.

At the least, such an analysis would entail:

- 1 clear identification of, and justification for, the desired outcome. Here there is a considerable amount of work to be undertaken in terms of ascertaining whether a problem exists and, if there is a problem, the extent of the problem in terms of the ‘undesirable’ competitive disadvantages borne by small business; and
- 2 assessment of options for achieving the desired outcome. Are tax measures the most appropriate and, if so, might systemic changes be more effective than specific tax concessions?

¹⁰⁵ Commonwealth, *A Guide to Regulation*, Office of Regulation Review (1998, 2nd ed) B9.

¹⁰⁶ Stanley Surrey, *Pathways to Tax Reform* (1974).

¹⁰⁷ Commonwealth, above n 84.

¹⁰⁸ *Ibid.*

1 *Defining Objectives of Small Business Taxation Expenditures*

It was noted earlier in this paper that small business tax concessions are generally justified upon the following grounds:

- 1 compensating small business for regressive tax compliance costs;
- 2 to promote neutrality by compensating for market failures which disadvantage small business;
- 3 to promote a relative form of tax neutrality, in the sense of ensuring that small businesses are treated comparably to other economic units;
- 4 promoting entrepreneurial endeavour;
- 5 achieving macroeconomic objectives such as securing economic stability by promoting the small business sector which possibly exhibits countercyclical growth by comparison to other sectors of the economy;
- 6 reducing small business taxes.

Underlying the first three of these objectives is the desire to level the playing field by compensating small business for actual or perceived competitive disadvantage. The fourth and fifth of the objectives listed above express the desire to generate small business growth. The last objective may be little more than providing government largesse to a favoured sub-community without requiring any broader community benefit. Although the legislature has referred to the first five objectives, there is little evidence to suggest that these objectives have been taken seriously. For example, the preceding discussion indicates that no serious effort has been made to identify and quantify the competitive disadvantages suffered by small business, let alone ascertain whether the various small business tax concessions represent the most effective means of redressing those disadvantages.

The first step in addressing the dysfunctional legislative process enveloping small business tax concessions is for the government to identify what the objectives of the small business tax concessions are, and make a commitment to identifying the best means of achieving these objectives. Assuming that some or all of the first five objectives in the above list are identified, it is then possible to undertake a tax expenditure analysis with respect to any existing or proposed small business advantage. A central aspect of identifying the objectives of small business tax concessions is to define the class of 'small business' taxpayers – only then can the significance of these objectives for the specified small business taxpayers be assessed. For example, it may be the case that the specified group of 'small business taxpayers' experience little competitive disadvantage, and so there is no need to consider small business tax concessions to redress such disadvantage. In this regard, there is no consensus regarding the definition of 'small business,'¹⁰⁹ and this is reflected in the various measures used for legislative and statistical purposes. Turnover,¹¹⁰ gross income,¹¹¹ business income,¹¹² net value of capital assets¹¹³ and number of

¹⁰⁹ OECD, above n 3, ch 3; Stewart Karlinsky, 'How Does US Income Tax Law Define a Small Business? Let Me Count the Ways' in Warren, above n 5, 45ff.

¹¹⁰ *ITAA97* s 328-365(1)(b).

¹¹¹ With respect to the classification of companies, the ATO uses the total gross income of the company as the basis for comparison: ATO, *Taxation Statistics 2003-04* (2006) 54.

¹¹² With respect to the classification of trusts, the ATO uses total business income as the basis for comparison: ATO, *Taxation Statistics 2003-04* (2006) 88.

¹¹³ *ITAA97* s 152-15.

employees¹¹⁴ are the measures generally applied. However, in applying any of these measures the identification of the upper threshold is essentially arbitrary. Thus, for example, in the Budget 2006-07 it was announced that the STS maximum annual turnover threshold would be increased from \$1 million to \$2 million.

The absence of a consensus definition of a 'small business' is most probably attributable to the heterogeneity of small businesses. Ranging from 'lifestyle businesses'¹¹⁵ to substantial commercial enterprises, there are a number of variables which make the targeting of tax concessions at small business, and at particular kinds of small business, extremely complex. These variables include:

- 1 number and type of entities within the 'management unit';
- 2 number and type of taxes borne by the business unit, and the number and type of rules with respect to each tax which apply to the unit;
- 3 number of 'employees' (ie self-employed sole proprietor vs 19 full time employees vs 50 part-time employees);
- 4 industry sector (manufacturing, mining, services);
- 5 number of transactions (ie consultant providing services under several contracts vs corner store with hundreds of transactions per day);
- 6 type of transactions (ie cash or invoice);
- 7 situs of business activity (ie dispersed or localised);
- 8 value of assets;
- 9 class of assets held (ie depreciating assets vs other capital assets such as real property); and
- 10 degree of risk assumed by proprietor.

This is by no means a complete list of small business variables but it suffices to make the point that if the government wishes to pursue any of the first five objectives of small business concessions listed above, gathering relevant data in order to ascertain the nature of net competitive (dis)advantage experienced by various types of small business, having regard to the range of small business tax advantages outlined earlier in this paper, is a lengthy and difficult task which has hitherto been ignored.

For example, if public expenditure in promoting entrepreneurship is a worthy objective (as opposed to leaving entrepreneurship to the private sector), there is a range of qualitative data which would be extremely useful in framing appropriate public programs. It would be fruitful, for example, to know the extent to which entrepreneurs are aware of the existing small business tax concessions and the extent to which these concessions influence entrepreneurial behaviour. Further, research might also explore a number of themes, including the 'marketing' of existing small business tax concessions to consideration of how those concessions might be simplified with a view to making them more marketable. Moreover, the research might indicate that small business tax concessions are less significant than other factors in promoting entrepreneurial endeavour ie access to finance/protection from oppressive conduct, in which case the justification for small business tax concessions would have to be questioned.

Even within the more developed literature regarding taxation compliance costs, the data is deficient in terms of identifying the particular industries, entity categories, transactions and stage

¹¹⁴ Australian Bureau of Statistics, *Small Business in Australia 2001* (2002) 1-2.

¹¹⁵ Freedman, above n 86, 15.

of the business lifecycle most affected by regulatory compliance burdens. Such data is essential, however, if the introduction of small business tax concessions is to be justified. Moreover, this data is critical to successfully targeting any proposals for small business tax concessions which emerge from the first, justificatory, stage of critical review. If the government genuinely wishes to achieve any or all of the objectives for small business concessions listed above, it is necessary either:

- 1 to identify common competitive disadvantages or common characteristics of all small businesses such that a ‘one size fits all’ small business tax concession can be developed — an extremely difficult task given the heterogeneity of small businesses; or alternatively
- 2 to identify different subcategories of small business and develop a more complex array of interlocking or contiguous tax concessions which collectively provide appropriate levels of assistance to the different categories of small businesses. It is possible that this is the overarching purpose behind the array of Australian small business tax concessions, although no such logic is expressly referred to in the relevant extrinsic materials. Given the heterogeneity of small businesses, such a program of independent tax concessions will encounter the problem of magnifying tax complexity.

2 *Considering Options*

The difficulties of targeting tax concessions are not necessarily a good reason to desist from providing such concessions. However, they are cause to critically reflect upon whether there are more efficient means of fostering small business growth and entrepreneurship. For example:

- 1 might non-tax strategies such as the public provision of loan guarantees be more effective in providing leveraged assistance to small business?
- 2 might any such expenditure programs be effectively combined with targeted tax system reform?; and
- 3 whether a tax compliance dividend can be reaped from tax reform which reduces compliance costs for small businesses. In this regard the possibility of introducing a presumptive taxation regime with respect to Australian small businesses ought to be explored.¹¹⁶

Only after such issues have been explored and the information is publicly available will it be possible to inform all stakeholders and commence a process of active engagement in policy making.

V CONCLUSION

In the recent past the discourse regarding small business taxation has come to be dominated by the perception that small business, the ‘engine room’ of the Australian economy, has been sorely dealt with at the hands of oppressive government regulation. In response to this perceived crisis, politicians and bureaucrats appear to fall over themselves in inventing new ways to compensate small business for this burden of injustice. What is striking is the apparent lack of interest in ascertaining, on a holistic basis, whether or not this portrayal of small business competitive disadvantage is supported by evidence. Certainly, there is a growing body of literature regarding the regressive compliance costs borne by small businesses, but the literature is remarkably silent when it comes to recognising the ‘hidden’ tax advantages which afford small businesses

¹¹⁶ See ‘Criminal Tax Advantages’ above.

substantial advantages. Until such tax advantages are comprehensively listed and quantified and other forms of government assistance provided by all levels of government are also identified and quantified, it is impossible to determine whether or not small business should receive compensation in the form of tax expenditures. Further, until some effort has been made to identify the types of small businesses which are net losers as a result of the operation of Australian taxation laws, the targeting of small business tax concessions is more an act of faith than an act of public finance 'science'.

There is clearly a need for much more stringent research in relation to small business taxation. The suggested definition of small business tax advantage proffered in this paper is a first step in this direction. Failing to ground small business taxation policy upon such rigorous application of good governance norms will only foster public cynicism which will undermine the perceived legitimacy of the Australian tax system.

THE TAX OFFSET FOR ENTREPRENEURS: A CRITICAL REVIEW OF THE 25 PER CENT TAX OFFSET FOR SMALL BUSINESS

JOHN McLAREN*

From 1 July 2005, small business taxpayers using the Simplified Tax System and with a turnover of \$50,000 or less are allowed a tax offset of 25 per cent on their tax payable. If turnover exceeds \$50,000, the tax offset phases out at 1 per cent until the turnover reaches \$75,000. This tax concession was part of the government's election statement made on 26 September 2004 in which the government stated that it wanted to assist and encourage small business entrepreneurs, particularly those set up from home. The steps involved in calculating the amount of tax offset that can be claimed are complicated where the business is structured as a trust or partnership and also where the taxpayer earns other income not just from the business. The offset also requires the small business taxpayer to be in a position to actually pay income tax before the tax offset provides any advantage, so that non-taxpaying small businesses receive no assistance. This paper critically reviews the 25 per cent tax offset and suggests alternative ways in which entrepreneurs could have been assisted by the tax system, for example, a reduced rate of income tax.

I INTRODUCTION

The Australian government recognises that an important driver of a strong economy is growth in small to medium enterprises ('SMEs'). In the 2004 federal election policy statement promoting an Enterprise Culture, the government announced a number of measures designed to foster the entrepreneurial spirit of small businesses. The government stated that it would provide further incentive and encouragement to small businesses — particularly those that set up and operate from home — through the introduction of a tax offset for entrepreneurs. The proposed new tax benefit is targeted at very small, micro and home-based businesses that are in the Simplified Tax System ('STS'). This approach is in line with the view of the OECD that 'innovative start-ups or small firms have played an important role in spurring productivity growth in OECD countries in the 1990s'.¹

From 1 July 2005, small business taxpayers using the STS and with a turnover of \$50,000 or less are allowed a tax offset of 25 per cent on their tax payable. If the turnover exceeds \$50,000, the tax offset phases out at 1 per cent or every \$1,000 until the turnover reaches \$75,000. This means that when taxpayers prepare their tax returns after 30 June 2006, for the financial year 2005-2006, they will claim the 25 per cent tax offset as a reduction in the amount of tax payable. The Australian financial year runs from 1 July to 30 June, unless the Australian Taxation Office, ATO, allows a business to adopt a substituted accounting period.

* LLB (Tas), MBA (Mon), LLM (Mon), Lecturer, School of Accounting and Law, RMIT University.

¹ OECD Directorate for Science, Technology and Industry, 'Entrepreneurship and Growth: Tax Issues' (2002) 7 < <http://www.oecd.org/dataoecd/10/19/2079715.pdf> > at 15 March 2006.

The offset is ‘targeted at very small, micro and home based businesses that are in the simplified tax system’.² The Federal Treasurer said of the offset:

The 25 per cent entrepreneurs’ tax offset contained in the recently passed *Tax Laws Amendment Measures No 7 Act 2004* (Cth) is expected to deliver a benefit to 540,000 Australian small businesses. The offset is available to businesses with a turnover of \$50,000 or less while businesses with a turnover up to \$75,000 will also benefit. The maximum possible benefit depends on the amount of tax that would otherwise be paid. By way of example, the Treasurer pointed out that if a company has a turnover of \$50,000 the maximum tax it would pay is \$15,000 (i.e. 30 per cent of \$50,000) with the 25 per cent offset reducing this tax liability by \$3,750 to \$11,250. Moreover, if the business is not a company, such as a sole trader, then the maximum tax it would pay on \$50,000 turnover would be \$11,172 (i.e. after the application of the tax free threshold and lower marginal tax rates) which the 25 per cent offset would reduce by \$2,793 to \$8,379.³

II DETAILED OPERATION OF THE CONCESSION

The entrepreneur’s tax offset is in Subdivision 61-J of the *Income Tax Assessment Act 1997* (‘ITAA97’). In order to derive the maximum benefit of the 25 per cent tax offset, the business must be in the STS in Division 328 of the *ITAA97* and must have an annual net STS turnover of less than \$50,000. In that situation, the full 25 per cent tax offset applies. However, the tax offset shades out by 1 per cent for every \$1,000 of net STS turnover in excess of \$50,000, so that by the time the business reaches more than \$75,000 in net turnover, the tax offset is no longer applicable.

It should be acknowledged at the start that any measure to reduce the income tax burden on business, and in particular small business in Australia, is a step in the right direction, given the comparative rates of tax that apply in the Asia-Pacific region.⁴ However, using the tax system to attempt to encourage growth in small business may not be the ideal approach, and the purpose of this paper is to critically analyse the new 25 per cent tax offset for entrepreneurs as well as propose areas that need further research and further options that may be considered to promote the financial health of small businesses in Australia. Burton, in his paper on ‘the Australian small business tax concessions’ argues that one of the reasons why STS arrangements have not been a success is because the government failed to conduct sufficient research on the needs of small business.⁵ Once again, the government acknowledged that there had been insufficient time to consult widely on the 25 per cent tax offset prior to its introduction.⁶ The government chose to provide a ‘tax offset’ rather than a tax incentive based on generating additional tax deductions such as depreciation allowances, and this means that in order to take advantage of the tax benefit, the business must be in a position where it pays income tax, otherwise the benefit is of no value. Small businesses, in their early years usually have expenses that substantially reduce the overall profitability of the business and thus the amount of tax payable. The tax offset may not be that important in the early life of a small home-based business for this reason. A tax offset reduces the amount of income tax that is payable by the taxpayer. The amount of tax payable is determined by the amount of taxable income derived by the taxpayer, multiplied by the applicable tax rate.

² Commonwealth, *Parliamentary Debates*, House of Representatives, 8 December 2004, 3 (Mal Brough, Minister for Revenue and Assistant Treasurer); Commonwealth, *Parliamentary Debates*, Senate, 7 March 2005, 90 (Robert Hill, Minister for Defence).

³ Peter Costello, Federal Treasurer, ‘Tax Cut for Small Businesses’ (Press Release, 17 March 2005).

⁴ For example, in Singapore the company tax rate is 20 per cent and in Hong Kong it is 16 per cent. Singapore also provides a partial exemption and zero tax rate for start-ups in the first three years of incorporation.

⁵ Mark Burton, ‘The Australian Small Business Tax Concessions — Public Choice, Public Interest or Public Folly?’ (2006) 21 *Australian Tax Forum* 71.

⁶ Explanatory Memorandum, *Tax Laws Amendment Measures No 7 Bill 2004*, 18.

The amount of taxable income is determined by the amount of assessable income derived by the taxpayer less any allowable deductions. The following formula illustrates the way in which the tax payable is calculated:

Gross Income	
<u>Less: Exempt income (s 6-20 and Div 11)</u>	
= Assessable Income (s 6-5 and s 6-10)	
<u>Less: Allowable Deductions (s 8-1 and Div 25)</u>	
= Taxable Income x Tax rate + Medicare levy (1.5 per cent) + (surcharge 1 per cent if applicable)	
= Tax payable - <u>Less: tax offsets + rebates</u> =	
Tax refund or payment to ATO	[all sections are contained in the ITAA97]

An obvious weakness in the 25 per cent tax offset to encourage entrepreneurs is that the threshold for the benefit is only \$50,000 and phases out at \$75,000. This means that only very small businesses are given assistance. If this is compared with other countries such as Canada where the low corporate tax rate threshold has been lifted from \$225,000 to \$300,000, it makes the Australian experiment look very limited in its application.⁷ In British Columbia, the combined federal and provincial corporate tax rate for small businesses is as at 1 January 2006 only 17.6 per cent whereas for large businesses the corporate tax rate is 34.1 per cent.⁸

The extra compliance costs involved in a taxpayer claiming the 25 per cent tax offset may well outweigh any financial advantage to be gained, especially where the taxpayer has other income that must be separated from the business income. For example, the tax saving may be less than the actual accounting costs involved in claiming the tax offset due to the additional work in separating items of assessable income into 'business income' and 'other income'. This weakness in the Australian experiment will be discussed in detail below.⁹

III SIMPLIFIED TAX SYSTEM - STS

A prerequisite for an entrepreneur to be eligible for the tax offset is that the business must qualify as an STS taxpayer. It is important to understand what is involved in being an STS taxpayer and the benefits associated with being in the particular tax system. The Australian government introduced the Goods and Services Tax ('GST') on 1 July 2000 as well as further tax reforms relating to the payment of income tax by business either quarterly or monthly depending

⁷ David Fletcher, 'Positioning Canadian SMEs for World Leadership' (Dec 2003/Jan 2004) *CMA Management* 78.

⁸ KPMG Canada, *Federal and Provincial Tax Rates for Income Earned by a CCPC 2006-2007* (2006) <http://www.kpmg.ca/en/services/tax/documents/2006_per_cent202007_per_cent20CCPC_per_cent20June06.pdf> at 4 July 2006. The Federal tax rate is 13.1 per cent and the Provincial rate is 4.5 per cent for British Columbia. The Provincial rates range from 3 per cent for Alberta to 8.5 per cent for Quebec.

⁹ Michael Dirkis and Brett Bondfield, 'The RBT ANTS Bite: Small Business the First Casualty', (2004) 19 *Australian Tax Forum* 107, contend that instead of simplifying the tax legislation, the government has introduced tax concessions as a means of compensating small business for the increase in compliance costs. However, the 25 per cent tax offset simply adds to the compliance costs and adds further layers of complexity to the legislation. Dirkis and Bondfield conclude that the STS and the tax concessions have not provided sufficient compensation for the additional compliance costs to small business.

on the turnover of the business. After the first year with GST and the new payment arrangements, small business was faced with extensive compliance costs and the government introduced a range of tax benefits to compensate business in the form of the STS.¹⁰

For income years starting after 30 June 2001, taxpayers whose income and assets do not exceed specified limits can use the simplified tax system in Division 328 of the *ITAA97*. A taxpayer enters the STS by electing to be ‘an STS taxpayer’. In order to be eligible to be an STS taxpayer, the business must satisfy the following two-eligibility criteria:

- 1 The entity must carry on a business during the year; and
- 2 The STS average turnover of the business and related businesses for the year must be less than \$2 million net of GST credits.¹¹

The way in which assessable income is calculated is varied for an STS taxpayer, and the following arrangements apply:

- 1 When the STS was first introduced, the business could only account for its income and deductions on a cash basis. However, the mandatory use of cash accounting ceased from 1 July 2005 and now STS taxpayers have a choice of using cash or accruals accounting to calculate their assessable income.
- 2 The capital allowance rules are varied to provide:
 - (a) An immediate deduction for assets costing less than \$1,000;
 - (b) Pooling for other depreciating assets into 2 pools, with accelerated depreciation rates applying to each of the 2 pool balances; and
 - (c) Simplified accounting for the private use of depreciating assets: Subdivision 328-D.
- 3 The taxpayer is permitted to ignore the difference between the opening and closing value of trading stock up to \$5,000: Subdivision 328-D.
- 4 Prepayments are deductible when paid if they relate to ‘things’ that will be completed within 12 months.

Once a taxpayer qualifies as an STS business, they become eligible to claim the 25 per cent tax offset when they complete their tax return. Given that a business must have a turnover of less than \$2 million to enter the STS system, it may have been of more benefit for the entrepreneur to have been allowed a lower tax rate with a turnover limit of \$2 million rather than the \$50,000 for the tax offset.¹² All taxpayers using STS must notify the Australian Taxation Office (‘ATO’) that

¹⁰ For details on why the government introduced the STS regime see ch 17 of Commonwealth Government, *A Tax System Redesigned* (1999). The Explanatory Memorandum to the *New Business Tax System (Simplified Tax System) Bill 2000* reinforces the point that potentially 850,000 businesses, being 95 per cent of all eligible businesses, would be able to adopt the STS because their turnover was less than \$1 million. The government relied upon the report into compliance costs by C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance* (1997).

¹¹ In the May 2006 Federal Budget, the government announced that as from 1 July 2006 the additional requirement for a business to have less than \$3 million of depreciating assets before they can enter the STS has been removed. The Budget also increased the turnover requirement from \$1 million to \$2 million: www.budget.gov.au.

¹² The then-leader of the Opposition, the Honourable Kim Beazley in his address to the Confederation of Small Business of Australia at the National Small Business Summit in Sydney on 17 May 2005, was critical of the 25 per cent entrepreneurs offset on the basis that the business must satisfy the STS requirement of having a turnover of less than \$1 million, (as was the case at that time), but now \$2 million, when some small businesses have a greater turnover but less than \$50,000 of taxable income. He cited two examples of businesses with very high turnovers but low profit margins, Enjo and Nutrimetics that would not be eligible for the 25 per cent tax offset.

they are using the simplified system so this would assist in deterring tax avoidance with a lower tax rate. The ATO has a record of all STS taxpayers so that the auditing process could be conducted effectively, if required.

One issue peculiar to Australia is that small businesses are structured in one or more of the following ways:

- 1 Sole trader;
- 2 Partnership;
- 3 Company; or
- 4 Trading trust with either the trustee paying tax or the beneficiaries.

A lower company tax rate would benefit businesses structured as companies but it would not help businesses structured as trading trusts where most of the income is taxed at individual rates. In Australia, the individual rates of tax are considerably higher than the company tax rate. The following resident individual rates apply for the financial year 2006-2007 under Schedule 7 of the *Income Tax Rates Act 1986 (Cth)*:

Taxable income	Tax payable
\$0 – \$6,000	Nil
\$6,001 – \$25,000	15 per cent for each \$1 over \$6,000
\$25,001 - \$75,000	\$2,850 plus 30 per cent for each \$1 over \$25,000
\$75,001 – \$150,000	\$17,850 plus 40 per cent for each \$1 over \$75,000
Over \$150,001	\$47,850 plus 45 per cent for each \$1 over \$150,000

Individual resident taxpayers also pay a further 1.5 per cent of their taxable income towards medical expenses incurred by the government, known as the ‘Medicare levy’.¹³

IV HOW THE 25 PER CENT TAX OFFSET WORKS

The government recognised that when small businesses are being established proprietors may need to supplement their income by working as a salary or wage earner and this income has to be taken into account when calculating the 25 per cent tax offset if there is business income. There may even be situations where a taxpayer is engaged in more than one business and each business is eligible to claim the 25 per cent tax offset. It is for these reasons that the 25 per cent tax offset rule in Division 61 of the *ITAA97* is perhaps more complex than would have been expected and may result in substantial compliance costs being incurred by the taxpayer. The different scenarios are not discussed in this article other than the basic example.¹⁴ The different scenarios covering situations where the taxpayer is structured as a trading trust or with non-business income are described in full in the Explanatory Memorandum.

The law relating to the 25 per cent tax offset is contained in Subdivision 61-J of the *ITAA97*. The offset is available to the following range of taxpayers:

- The STS taxpayer in the case of an individual or company operating as an STS taxpayer;

¹³ A further 1 per cent Medicare Levy surcharge is paid by the individual taxpayer if they do not have private hospital insurance and their taxable income exceeds \$50,000 for a single person and \$100,000 for a family with one child. The threshold increases with each additional child.

¹⁴ Explanatory Memorandum, *Tax Laws Amendment Measures No 7 Bill 2004*, 20-27.

- The partners of a partnership that is an STS taxpayer; or
- The trustee or beneficiaries of a trust that is an STS taxpayer, depending on who is liable for tax on the trust income.

The Explanatory Memorandum provides the following information on the implications of claiming the offset. Small businesses in the STS will need to calculate their turnover and their net income from business. Taxpayers with other non-business income will need to isolate their business income from their total income. This measure will increase administrative costs for the ATO as well as taxpayers. The ATO will have to change the tax return forms and systems changes will also be required to capture the required data and undertake the calculation of the tax offset. It will also require extending the STS.

A taxpayer may be eligible for more than one tax offset. For example, if a taxpayer is a sole trader who has elected into the STS and that taxpayer is also a partner in a partnership that has also elected into the STS, the taxpayer may be entitled to a tax offset in respect of their income as a sole trader and also in respect of their share of the STS income from the partnership, s 61-500 of the *ITAA97*. However, if the sole trader and the partnership are grouped entities, the amount of STS group turnover is relevant to determining eligibility for an offset.

V NET STS INCOME AND STS ANNUAL TURNOVER

Regardless of whether the tax offset is available to the STS taxpayer, a partner, a trustee or a beneficiary, there must be an amount of net STS income before an entitlement to an offset arises. That is, the entity claiming the offset must have net STS income for the year. The entity eligible for the offset must have a share of that net income included in its assessable income in order to be eligible for an offset.

An entity's net STS income for an income year is the amount by which:

the entity's STS annual turnover for the year

exceeds

the sum of the entity's deductions attributable to the turnover,

Where STS annual turnover for a year is the total of the value of the business supplies the entity made in the year, ss 61-525(1) and (2) of the *ITAA97*. The deductions attributable to the STS turnover are the allowable deductions that the entity can claim against its assessable income which specifically relate to that turnover.

The Explanatory Memorandum specifically introduces these terms of 'net STS income' and 'STS annual turnover' for the first time into the income tax law. The definition section, s 995-1(1) *ITAA97* is amended to include a definition of those two terms. The way in which the 'net STS income' is determined is in practice no different from the way a taxpayer calculates their 'taxable income', namely assessable income less allowable deductions.

The question must be asked, why overly complicate the new law relating to the tax offset with new definitions? What was wrong with calculating the taxable income of the STS business but excluding expenses that are not directly associated with the business, such as share trading

activities or a negatively geared investment property? The following example is used in the Explanatory Memorandum to illustrate this point.¹⁵

A Example

Fred is an STS taxpayer who sells home-made greeting cards via the Internet. Fred's STS annual turnover is \$35,000 for the year. Fred runs his business from a home office. Fred claims deductions for his business expenses such as the cost of the materials used in making the greeting cards, stationery, postage and the electricity expenses relating to the home office. These business expenses total \$5,000. Fred also has salary and wage income of \$75,000 for the year. He is a member of a trade union and he subscribes to a professional journal. His work-related expenses total \$1,200. Fred also has a negatively geared share portfolio from which he receives \$5,000 worth of dividends and has \$6,000 of interest expenses related to borrowings to acquire the shares. Fred therefore makes a loss for taxation purposes of \$1,000 from his share investments.

Fred's net STS income for the year is the amount by which his STS annual turnover of \$35,000 exceeds his deductions attributable to that turnover of \$5,000. Therefore, his net STS income is \$30,000. Fred's work-related expenses and the expenses relating to his share of investments do not affect his STS annual turnover. The income from Fred's share investments is not included in his STS annual turnover, as the dividends do not constitute taxable supplies.

The definition of 'STS annual turnover' is consistent with the broader definition of STS group turnover in s 328-375 of the *ITAA97*. The turnover of a business reflects the ordinary activities of carrying on that business, such as the sale of goods and the provision of services, and also includes interest received on amounts deposited in business banking accounts. The turnover does not include items such as dividends, rental income where the rental activities do not form an ordinary part of the business or amounts resulting from realisation of an investment. This distinction will cause small business operators to have to change their accounting system and incur additional accounting costs in having their tax return prepared.

VI EXAMPLE OF A CLAIM FOR THE TAX OFFSET FOR AN INDIVIDUAL OR A COMPANY

A taxpayer is entitled to a tax offset for an income year under s 61-505(1) of the *ITAA97* if the following conditions are satisfied:

- the taxpayer is an individual, operating as a sole trader or a company;
- it has elected to be an STS taxpayer for the year;
- it has STS group turnover of less than \$75,000 for the year; and
- it has net STS income for the year.

A Calculation of the Offset

If the STS group turnover is \$50,000 or less, the taxpayer is entitled to a tax offset of 25 per cent of their income tax liability that is attributable to STS income. If the STS group turnover is more than \$50,000, the tax offset is phased out until it equals zero at turnover of \$75,000. The offset is calculated using the following method in s 61-505(2) of the *ITAA97*:

¹⁵ Ibid 16.

Step 1: Calculate taxable income for the year.

Step 2: Calculate 25 per cent of the basic income tax liability for the year on the taxable income; that is, using the applicable tax rates and taking into account any special provisions that affect the calculation of the liability. Note: the basic income tax liability does not take into account any tax offsets.

Step 3: Calculate the STS per centage, which cannot exceed 100 per cent, as:

$$\frac{\text{The taxpayer's net STS income for the year}}{\text{The taxpayer's taxable income for the year}} \times 100$$

Step 4: If the STS group turnover is \$50,000 or less, multiply the step 2 amount by the STS per centage to determine the amount of the tax offset.

B Example: Sole trader with other non-business income¹⁶

Jenny runs a physiotherapy practice from her home and she is an STS taxpayer for the income year commencing 1 July 2006. The net income from her practice is \$20,000 (i.e. \$30,000 turnover less \$10,000 business expenses). In addition, she has a part-time job as a shop assistant from which she receives salary and wages of \$25,000.

Step 1: Jenny's taxable income for the year is \$45,000.

Step 2: Basic income tax liability is \$8,850.

$$25 \text{ per cent of her basic income tax liability is: } 25 \text{ per cent} \times 8,850 = 2,212.50$$

Step 3: The STS per centage is: $\frac{20,000}{45,000} \times 100 = 44.44 \text{ per cent}$

Step 4: Jenny's STS group turnover is \$30,000; therefore, the tax offset is:
 $2,212.50 \times 44.44 \text{ per cent} = 983.24$

Step 5: Not applicable.

Therefore, Jenny's entrepreneurs' tax offset is **\$983.24**.

VII THE RECOMMENDED OPTION CHOSEN BY THE AUSTRALIAN GOVERNMENT

The government had three options to consider when introducing the tax offset. Given that the individual tax rates are not the same as the corporate tax rate and with individuals being eligible for the first \$6,000 being tax-free and the income tax rates being progressive from there up to 45 per cent, there is an advantage if you operate as an individual and the top slice of income is subject to the offset, but at a disadvantage if the bottom slice of income is taken into account in determining the tax offset. The other option was to take the top slice of income and make that eligible for the tax offset, but that would advantage individuals over companies. In the end the

¹⁶ Ibid 26.

government opted to take the average tax rate as the preferred approach. The government was of the opinion that this approach would deliver the required policy objective with reduced compliance costs to taxpayers and the ATO.

VIII REVENUE COST TO THE GOVERNMENT

The financial cost to the revenue as a result of the introduction of a 25 per cent entrepreneurs' tax offset is expected to be as follows, based on average rates of tax:¹⁷

2004-05	2005-06	2006-07	2007-08
Nil	Nil	-\$400 m	-\$390 m

IX ISSUES FOR CONCERN — WILL THE 25 PER CENT TAX OFFSET ENCOURAGE ENTREPRENEURS IN AUSTRALIA?

The following areas of tax law are of concern in reconciling the value of the 25 per cent tax offset with the additional compliance costs facing small business. First, is the home-based business a hobby and therefore not eligible for the tax offset? Second, why do we have the non-commercial loss provisions in Division 35 of the *ITAA97* if the government believes that home-based businesses are making a profit and will pay tax in order to claim the tax offset, and how will small business become more profitable as a result of the tax offset? The new law appears to be an overly complicated implementation of a good idea aimed at reducing costs for a small business. The complications arise from the requirement to use specific calculations and formulas where a business is being conducted, for example, by a husband and wife partnership, where business and non-business income is being mixed. A simple idea of having the tax offset now appears to be part of a very complex tax system that appears to be in conflict with other parts of the *ITAA97*, in particular the non-commercial loss provisions.

A *Hobby versus Business*

Many small home-based businesses are run as a hobby and not strictly as a business. In many instances the tests laid down in the case of *Ferguson v Federal Commissioner of Taxation*,¹⁸ that are used to determine whether or not a business is being conducted would not be satisfied by the home-based business, especially if the turnover is likely to be less than \$50,000. There may be many small home-based businesses that may miss out on the 25 per cent tax offset for this reason. This is an issue that will need further clarification from the government in the future.

¹⁷ Given that as at 17 April 2003 only 14 per cent of eligible taxpayers had adopted the STS arrangement it is highly unlikely that the above figures are a true indication of the cost to revenue of the 25 per cent tax offset. See Australian Tax Practice, 'Simplified Tax System (STS): 14 per cent Take-up Rate So Far', *ATP Latest Tax News*, Issue 163, 25 August 2003.

¹⁸ (1979) 9 ATR 873.

B *Structure of the Business*

When deciding to establish a business, most people ask for advice on what is the best structure to use. Any advice on the ideal choice of business structure focuses on a number of concerns such as the following:

- 1 The need for capital now and in the future and the best way to obtain this either through loan capital or share capital;
- 2 Asset protection in case the business fails or there are problems within the family that require assets to be out of reach of family members;
- 3 Tax minimisation using the current law such as income splitting through the use of a discretionary trading trust; and
- 4 Ease of disposal of the business in the future and being able to utilise the small business capital gains tax concessions in Division 152 of the *ITAA97* on the sale of the business.

These are just a few of the issues that are taken into account in choosing a structure in which to operate a business. The age of the entrepreneurs, their marital status, numbers of dependants, their risk profile, health are all factors that must be taken into consideration. People that have retired before the age of 65 years, and are still active and wish to supplement their retirement income are now generating much of the growth in small home-based business. These businesses are being established in the services sector, such as home help with cleaning, gardening, and home maintenance. The 25 per cent tax offset, which was introduced without wide public consultation, appears to have missed the issue of how a small business is structured.

C *Actual Tax Saving*

If a husband and wife decide to retire from their salaried positions and establish a small home-based business, the following scenario illustrates the actual tax benefit of the 25 per cent tax offset for a carefully structured small business. Assume that the husband and wife establish a company because they want to trade as a separate legal entity for asset protection purposes and continuity of business benefits, as the company will not die. They have also been advised that they can be employed by the company and the company can make provision for superannuation contributions (their retirement fund).

An assumption is made that in the first year the company makes \$60,000 gross STS income. They deduct business expenses of \$10,000 and total salaries for each of them of \$19,000, being total expenses of \$48,000. The remaining profit of \$12,000 is paid to their superannuation fund which pays tax at the rate of 15 per cent on the contributions. The end result is that the company makes no taxable income for the year and no claim is made for the 25 per cent tax offset. If the business had paid income tax on the \$50,000 at the company rate of tax they would have paid – $50,000 \times 30$ per cent = $15,000 \times 25$ per cent tax offset, their total tax payable would have been \$11,250 with the tax offset saving the company \$3,750.

If the husband and wife team proceed on the basis outlined above, their total tax payable is as follows, ignoring low-income rebate and other rebates and ignoring the fact that their superannuation contribution could have been increased.

Individual income tax on \$19,000 = $1,950 \times 2$ for the husband and wife = \$3,900.

Tax on the superannuation contribution is $12,000 \times 15$ per cent = \$1,800.

Total tax paid = \$5,700.

This provides a tax saving of \$5,550 without using the 25 per cent tax offset.

The fact is that small home based businesses try to avoid paying any income tax in the business entity (here, a company) if there are options to distribute the income in the form of a salary to an individual who can take advantage of the tax-free threshold of \$6,000. In the case of small businesses being operated by semi-retired people, the focus is on generating superannuation contributions that attract a 15 per cent tax rate.

The conclusion that follows from the above scenario is: Why not consider a tax-free threshold for small business, such as the first \$6,000 of taxable income being tax-free or even no income tax in the first three years?

D *Compliance Costs*

The calculation for claiming the 25 per cent tax offset is quite complex where the taxpayer has other income as well as business income. If the taxpayer is relying on their tax agent to prepare the tax return on the basis of claiming the 25 per cent tax offset, then additional fees will be incurred. The tax offset, given the small turnover allowed, namely \$50,000, means that the tax saving may be less than the additional costs involved in having the financial accounts and annual tax return prepared so that the offset can be claimed.

X ISSUES WITH THE EFFECTIVENESS OF THE OFFSET AND ALTERNATIVE FORMS OF ASSISTANCE

Successive Australian governments have used the tax system to influence the financial behaviour of individuals and businesses. The STS is a perfect example of the tax system being used to assist small business by attempting to reduce the tax compliance costs of doing business but also increasing tax deductions through generous depreciation allowances. The introduction of a Pooled Development Fund ('PDF') regime and the very generous tax concessions for research and development partnerships were designed to attract investment into risky businesses and the research and development industry. The PDF regime provides tax benefits through providing a tax rate of 15 per cent for PDFs on their business income and a 25 per cent rate on investment income. There is no income tax on PDF dividends in the hands of shareholders or capital gains tax on the sale of the shares.¹⁹

The new entrepreneur's tax offset appears to be overly complicated because of the need to allow for owners of these small home-based businesses to earn other income from salaries or wages. The compliance requirements would appear to add substantially to the costs of these small businesses. The government acknowledges that the compliance costs will add to the costs of the ATO in monitoring the new tax offset.

Would it be very difficult to provide small business with a similar tax concession of a 15 per cent tax rate on income up to say \$50,000 or \$300,000 as is the case in Canada?²⁰ At least there would be an incentive to pay income tax and any dividends received by shareholders, if a company structure was used, could be tax-free for the shareholders in exactly the same way as a PDF is treated for taxation purposes. Alternatively, or in addition, it may be appropriate to consider a system of direct grants to be available for small business similar to the grants being offered for commercialisation of new products and services.²¹ Grants and other forms of

¹⁹ Section 124ZY of the *Income Tax Assessment Act 1936*. In the May 2006 Federal Budget, the government announced that measures would be introduced to replace the existing PDF arrangements, www.budget.gov.au

²⁰ Fletcher, above n 7.

²¹ Austrade and AusIndustry grants and loans for business development.

assistance do require administrative support and cost the government money. However, based on the cost to revenue of the entrepreneur's tax offset as calculated by Treasury, the government could spend \$400 million in 2006-07 and \$390 million in 2007-08 and still be revenue neutral.²²

In summary, the following tax and financial options could be considered in light of the above discussion, as alternative ways to assist small home-based business in Australia:

- 1 A 15 per cent tax rate similar to the arrangements for a PDF.
- 2 Forms of direct grants to assist in establishing the business such as costs of incorporation etc. — say \$2,000 to \$10,000 as a direct grant or a loan at concessional rates of interest.
- 3 Introducing a tax-free threshold for small businesses similar to the individual tax-free threshold of \$6,000.
- 4 Increasing the turnover threshold from \$50,000 to say \$1 million, in line with the STS eligibility, so that the tax saving more than covers the additional compliance costs for the taxpayer and the ATO can monitor taxpayers in the STS.
- 5 Providing start-up small businesses with a tax free holiday for a period of three years similar to Singapore.

XI CURRENT RESEARCH ON THE EFFECT OF TAXATION AND ENTREPRENEURSHIP

Apart from research by the OECD on entrepreneurship and taxation involving Australia as a member of the OECD, very little research has been conducted in the last few years in Australia by other researchers. A recent article has examined the response of surveyed entrepreneurs to the Australian income tax.²³ The survey asked the following questions and the respondents were required to provide answers on the basis that they either agreed strongly, strongly disagreed or did not know. The same survey was used in ten other countries including the USA, Singapore, UK and a number of European countries. The statements put to respondents were as follows:

- The level of income taxes discourages people from starting new firms;
- The level of income taxes effectively stops people from growing firms;
- The level of income taxes deters people from seeking to become rich; and
- Income taxes reduce peoples' interest in attempting to accumulate wealth.

The authors found that the response of the participants to income taxes indicated that they did not believe that income taxes in Australia encouraged entrepreneurial activity. It is of interest to note that in the survey Australia finished third highest out of the ten countries with only the USA and Singapore rating higher as regards the attitude towards income taxes. This may be largely due to the fact that in the USA and Singapore, the rate of income tax is considerably lower than Australia, but the rate in Australia is considerably lower than that in European countries such as Sweden, Denmark, Finland and Norway.²⁴ The authors reached the following conclusion based on their research:

²² Revenue costs as shown in the Explanatory Memorandum, Tax Laws Amendment Measures No 7 Bill 2004, 33.

²³ M Jackson, C Morley and R O'Connor, 'Culture and attitudes fostering entrepreneurship: how does Australia compare?' (2006) 5 *International Journal of Knowledge, Culture and Change Management* 89.

²⁴ See the survey by the Australian Chamber of Commerce and Industry, '2004 Pre-Election Survey Small Business Priorities: Taxation, Economic Management & Workplace Relations', <http://www.acci.asn.au/text_files/issues_papers/Pre_Elect_Survey/Small_per_cent20Business_per_cent20Priorities_per_cent20_September_per_cent202004_.pdf> at 28 September 2006. The ACCI found that 83 per cent of

The statements about income taxes are phrased negatively, so that high scores would indicate a culture less conducive to entrepreneurs in respect of income taxes..... It would appear that the Australian income tax regime does not too strongly deter people from seeking to become rich, but does deter them from starting new firms. There is a possible contradiction here, in that starting a business is an important way for Australians to become rich. Overall, income taxes in Australia do not seem to be as encouraging of entrepreneurial activity as they could be.²⁵

Based on this research it would appear that the introduction of the 25 per cent tax offset by the Australian government is an important step in encouraging entrepreneurial activity in Australia. The only area of concern is whether it is the right type of development and whether it is enough. Only time will tell.

XII FURTHER ISSUES FOR RESEARCH

In the Explanatory Memorandum to the entrepreneur's tax offset, under the heading 'Other Issues — Consultation', it is stated that:

The Department of the Prime Minister and Cabinet and the ATO have been consulted on this issue. In view of the requirement to introduce legislation on 9 December 2004, there is not sufficient time to consult more widely.²⁶

This is perhaps the most obvious criticism of the new initiative: small business was not consulted and the government is taking it for granted that this measure will 'provide an incentive to kick-start small business and provide encouragement for small business growth'.²⁷ There are a number of associations in Australia that exist to help small business, as well as accountants, banks, and state government agencies. All of these bodies should now be consulted and after a period of, say, two years; the new tax offset should be assessed for its effectiveness in promoting and developing small business in Australia. There is, perhaps, a feeling that the 25 per cent tax offset was introduced as an election sweetener for small business and the tax benefit was not thought through sufficiently. There are enough reasons discussed above, to suggest that the 25 per cent tax offset may not be as warmly received by small business proprietors, as the government would like.

Both the government and small business associations when reviewing the effectiveness of the 25 per cent tax offset should consider the following list of issues:

- 1 What is the preferred choice of structure for a small business — company, trust or sole trader or partnership?
- 2 What is the demographic of the proprietors of the small businesses in Australia — retired or semi-retired or young entrepreneurs?
- 3 What is the impact of this tax offset on the desire of business owners to pay income tax rather than look for legal means to minimise tax such as the use of discretionary trusts?
- 4 The government specifically targeted small businesses operating from 'home'. Why is this important and is it consistent with other government policies?
- 5 What impact will the tax offset have on the generation of imputation credits for shareholders in small companies that want to receive fully franked dividends or even a superannuation fund as the shareholder?

respondents to their survey considered that personal tax was too high and 69 per cent considered that company tax was too high.

²⁵ M Jackson, above n 23, 96.

²⁶ Explanatory Memorandum, above n 6, 18.

²⁷ Ibid, 18.

XIII CONCLUSION

As was stated in the introduction to this article, any government measure to reduce the income tax burden on small business is to be applauded. It is also important to acknowledge the fact that the government recognises the need for Australia to encourage entrepreneurs to start and grow new businesses. This initiative should be seen as the start of future government initiatives in support of small business. It will be interesting to see what use is made of the offset by small businesses in Australia and the actual cost to the revenue. Given the history of the negative attitude of Australian small business taxpayers to the STS as evidenced by the very low up-take of that regime, it is hardly likely that the 25 per cent tax offset will be widely accepted by eligible taxpayers.²⁸ Treasury has estimated the cost to be \$400 million in 2006-07 and \$390 million in 2007-08. If this is not the actual cost and the figure is less, will the government then consider some other options for developing an entrepreneurial culture in Australia, say based on the discussion above?

²⁸ Australian Tax Practice, above n 17. The report goes on to state that the government anticipates that in a mature system around 60 per cent of eligible businesses would take up the STS. It is highly doubtful that a figure of 60 per cent has been achieved to date. It has been impossible to obtain any current published figures on the take-up rate now from the ATO or the Treasury websites.

THE COSTS AND BENEFITS OF COMPLYING WITH THE TAX SYSTEM AND THEIR IMPACT ON THE FINANCIAL MANAGEMENT OF THE SMALL FIRM

PHIL LIGNIER*

Empirical research carried out in different countries provides strong evidence that tax compliance costs impact more heavily on small firms. In addition, results showed that the regressivity of tax compliance costs according to size was even more accentuated after taking into consideration the effects of the cash flow and tax deductibility benefits of tax compliance. However, it has been suggested in the literature that business taxpayers could also be deriving managerial benefits as a result of complying with tax. These managerial benefits are expected to come in the form of a better knowledge of financial affairs and the improved decision-making that will be brought about by the more stringent record keeping imposed by tax requirements. The existing evidence indicates that these managerial benefits could be significant, particularly in smaller firms where accounting systems are initially undeveloped. The paper argues that the incidence of tax compliance activities on small businesses is still incompletely understood. Very little explanatory research has attempted to study the relationships between potential influencing factors and the magnitude of tax compliance costs. Likewise, the managerial benefits of tax compliance are still largely unexplored. It is argued that fresh empirical data and further investigation are needed in order to identify the conditions in which managerial benefits may be derived and to measure their impact on the financial management of the small firm.

I INTRODUCTION

Over recent decades, the cost of complying with taxation obligations has generated widespread interest among academics, government policy makers and business organisations. Most authors trace this renewed interest to the work undertaken by Cedric Sandford in the United Kingdom and overseas during the 1970s and 1980s.¹ In Australia, the cost of tax compliance has been the object of a significant number of research projects, many of them initiated and coordinated by the Australian Taxation Studies Program ('ATAX').² The growing complexity of tax systems, the introduction of Goods and Services Tax ('GST') or Value Added Tax ('VAT') legislative regimes — generally associated with high compliance costs — and the increased emphasis placed on self-assessment are among the reasons generally put forward to explain the increasing interest in compliance costs research.³

One essential characteristic of tax compliance costs revealed by empirical research is their regressive nature in relation to business size.⁴ Consequently, the financial burden of tax compliance appears to be much heavier for small firms than it is for large entities.

* BBus (Acc) (QUT), MCom (QUT), CPA; Lecturer in Taxation and Accounting, Central Queensland University. This chapter is based on research undertaken by the author as part of a PhD at Atax, UNSW.

¹ Sandford's seminal works include C Sandford, 'Improving the methodologies' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995); C Sandford, M Godwin and P Hardwick, *Administrative and compliance costs of taxation* (1989); C Sandford et al, *Costs & benefits of VAT* (1981).

² C Evans, 'Studying the studies: an overview of recent research into taxation operation costs' (2003) 1 *eJournal of Taxation* 64.

³ Ibid; C Sandford, 'Improving the methodologies' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995).

⁴ See, eg, C Evans et al, 'A report into the incremental costs of taxpayer compliance' (Australian Taxation Office, 1996); C Sandford and J Hasseldine, 'The compliance costs of business taxes in New Zealand' (Institute of Policy Studies, 1992); Yellow Pages, 'Working overtime: A National survey of the paperwork burden of small business' (Background Paper 3, Small Business Deregulation Task Force, 1996).

Sandford further argued that the operation of a tax system generates costs, but also benefits the taxpayer. In particular, he identified managerial benefits in the form of a better knowledge of financial affairs and improved decision-making brought about by compliance work and better record keeping.⁵ Managerial benefits have been discussed in a number of papers,⁶ however to date there is scant empirical evidence regarding their importance.

The burden imposed by tax compliance on small business has been documented and analysed by the Small Business Deregulation Task Force ('Bell Task Force') in Australia.⁷ Following the publication of the Bell report, a number of governmental initiatives, such as the preparation of Regulation Impact Statements, and the Simplified Tax System were introduced in an effort to alleviate the incidence of tax compliance on small businesses. However, almost ten years after the Bell report, many authors argue that small businesses, particularly micro-businesses are still faced with significant tax compliance costs.⁸

This paper examines the costs and benefits resulting from tax compliance activities in the context of Small and Medium Enterprises ('SMEs') for which particular attention is justified on several grounds. First, significant empirical research has established that the burden of tax compliance costs is felt more acutely by small businesses. Second, managerial benefits derived as a result of tax compliance activities are more likely to arise in smaller firms, because their accounting information systems are generally less developed. Both costs and benefits of complying with tax are being considered, however the emphasis in this paper is on managerial benefits which have been identified by some authors as an under-researched area.⁹

First, the paper introduces key definitions and concepts associated with tax compliance costs and benefits. Next, the costs incurred by SMEs while complying with tax are examined and analysed. Then, potential managerial benefits derived as a result of tax compliance activities are considered. This section will discuss the concept of managerial benefits, identify particular forms of managerial benefits and examine the empirical evidence on their significance. In the following section, theoretical issues relating to the measurement of tax compliance costs and benefits are discussed. Finally, areas that warrant further research are identified.

II DEFINITIONS AND CONCEPTS

A *What are Tax Compliance Costs?*

Throughout the tax literature, the term 'tax compliance costs', and its numerous related concepts, have been given a variety of definitions. One of the earliest definitions was proposed by Johnston who identified tax compliance costs as '[t]he reduction in the corporation's operating costs, exclusive of the tax itself, which would result if the federal tax were eliminated.'¹⁰ Sandford, Godwin and Hardwick described tax compliance costs as 'those costs incurred by taxpayers and third parties such as businesses in complying with a given structure

⁵ C Sandford, M Godwin and P Hardwick, *Administrative and Compliance Costs of Taxation* (1989) 89.

⁶ Eg C Sandford et al, *Costs and Benefits of VAT* (1981); Binh Tran-Nam et al, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) 53(2) *National Tax Journal* 229.

⁷ M Dirkis and B Bondfield, 'Small business: the first casualty of tax reform compliance costs' (Taxation Institute of Australia, 2004).

⁸ C Coleman and C Evans, 'Tax Compliance Issues for Small Business in Australia' in N Warren (ed) *Taxing Small Business: Developing Good Tax Policies Conference Series No 23* (2003).

⁹ B Binh Tran-Nam, 'Tax compliance costs methodology - a research agenda for the future' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs: A Festschrift for Cedric Sandford* (2001).

¹⁰ K S Johnston *Corporations' Federal Income Tax Compliance Costs* (Monograph No 10 thesis, Ohio State University, 1963) 5.

and level of tax.’¹¹ A few years later, Sandford gave a more comprehensive definition of tax compliance costs similar to Johnston’s, asserting that they are: ‘Costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities ... over and above the actual payment of tax; costs which would disappear if the tax was abolished.’¹²

As will be discussed later, the definition of tax compliance costs adopted has important implications on such issues as the disentanglement of tax and accounting costs and the identification of managerial benefits. The literature also introduces several key semantic concepts related to tax compliance. Although there seems to be a general consensus on the meaning of many of these concepts, slight differences in terminology can be noted.

Sandford, Godwin and Hardwick defined ‘taxation operating costs’ as the sum of public sector costs and private sector costs.¹³ Public sector costs correspond to administrative costs borne by the tax authorities while administering the tax code and other costs such the costs associated with the enactment of the legislation.¹⁴ Private sector costs are incurred by taxpayers and third parties while meeting the requirements of the tax system.¹⁵

Also of note are the ‘social costs of compliance’ (‘SCC’) which can be divided into the costs borne directly by the taxpayer (‘taxpayer compliance costs’) and economic efficiency costs.¹⁶ Economic efficiency costs result from the distortion in the pattern of consumption caused by the existence of a particular tax (‘distortion costs’).¹⁷

B *Gross and Net Compliance Costs*

Most published research adheres to the convention established by Sandford and distinguishes between gross compliance costs and net compliance costs.¹⁸ Net compliance costs are equal to gross compliance costs less tax compliance benefits. Benefits from tax compliance include cash flow benefits, tax deductibility benefits and managerial benefits.¹⁹

Some commentators have expressed doubts as to the validity of the term ‘net compliance costs.’ It has been contended, for instance, that cash flow benefits do not arise because of compliance and that gross compliance costs are a more appropriate measure to use as they reflect the economic resource cost of complying with the tax system.²⁰ Pope, Fayle and Chen, on the other hand, argued that net compliance costs are a good indicator of the effective burden of complying with the tax system.²¹

¹¹ Sandford, Godwin and Hardwick, above n 5, 10.

¹² C C Sandford, ‘The Rise and rise of tax compliance costs’ in C Sandford (ed), *Tax compliance costs measurement and policy* (1995) .

¹³ Sandford, Godwin and Hardwick, above n 5, 22.

¹⁴ Ibid 6.

¹⁵ Ibid 9.

¹⁶ B Binh Tran-Nam et al, ‘Tax compliance costs: Research methodology and empirical evidence from Australia’ (2000) 53(2) *National Tax Journal* 229.

¹⁷ Ibid.

¹⁸ See Sandford, Godwin and Hardwick, above n 5, 13–14.

¹⁹ Ibid.

²⁰ See I Wallschutzky, ‘The Compliance Costs of Taxes on Businesses and Individuals: A Review of the Evidence’ (Paper presented at the Compliance Costs of Business Taxation Workshop, Melbourne, [1990]); G. Smith, ‘Future developments in the taxation system’ (Paper presented at the Compliance Costs of Business Taxation Workshop, Melbourne, 1990) .

²¹ J Pope, R Fayle and D Chen, *The compliance costs of companies’ Income Tax in Australia* (1994).

C Other Classifications of Compliance Costs

The distinction between *avoidable* (corresponding to activities such as tax planning) and *unavoidable* costs has also been widely discussed in the literature.²² The question regarding the inclusion of avoidable costs in the evaluation of tax compliance costs has not received a conclusive answer as yet.

The literature also differentiates between *commencement*, *start-up* or *transitional* costs and *regular* or *recurrent* costs. Commencement costs may include expenses such as initial training or computer hardware and software.²³ Commencement costs pose a problem to the researcher since they occur once and make inter-temporal comparisons difficult. Tran-Nam et al also refer to *explicit* costs (i.e. involving direct payment by the taxpayer) in contrast to *implicit* (e.g. taxpayer's own time and unpaid helpers).²⁴

Finally, *psychic* or *psychological* costs first mentioned by Sandford have been attributed to the anxiety and frustration caused by complying with tax.²⁵ These costs are difficult to measure or quantify, however their existence is recognised in many research papers and government reports.²⁶ Research is currently being undertaken on this issue.²⁷

D Tax Deductibility Benefits

Tax deductibility benefits result from the fact that business taxpayers will be entitled to deductions for some of their compliance costs.²⁸ Such benefits were first considered by Johnston who computed the before-tax and after-tax compliance costs of the corporations which he studied.²⁹ While the reduction of tax payable will benefit the taxpayer, the aggregate value of tax deductibility benefits does not represent a benefit for the economy as a whole as it will be offset by revenue losses to the tax authorities.³⁰ The value of the tax deductibility benefit will depend on the marginal tax rate of the individual taxpayer or the corporate tax rate in the case of companies. The assumption made in most research is that the taxpayers are well informed and optimising and that they will claim the full tax deduction to which they are entitled.³¹

E Cash Flow Benefits

Cash flow benefits arise because of the difference between the time when money is collected by the taxpayer and the time when the tax is actually handed over to the tax authorities.³² As in the case of tax deductibility benefits, cash flow benefits are merely a transfer of costs between the taxpayer and the tax authorities.³³ The value of cash flow benefits depends on four variables:

²² See Johnston, above n 10; Sandford, Godwin and Hardwick, above n 5; J J Pope, R Fayle and M Duncason, *The compliance costs of Personal Income Taxation in Australia 1986-87* (1990).

²³ Sandford, Godwin and Hardwick, above n 6, 16.

²⁴ Tran-Nam et al, above n 16, 236.

²⁵ Sandford, Godwin and Hardwick, above n 5, 18.

²⁶ See, eg, S Saumen Chattopadhyay and Arindan Das-Gupta, 'The compliance costs of the personal income tax and its determinants' (National Institute of Public Finance and Policy, 2002); Business NZ and KPMG, 'Summary report of the Business New Zealand- KMPG compliance costs survey' (Business New Zealand, 2004).

²⁷ R Woellner et al, 'Taxation or vexation: measuring the psychological costs of tax compliance' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs : A Festschrift for Cedric Sandford* (2001).

²⁸ Tran-Nam et al, above n 16, 238.

²⁹ Johnston, above n 10, 10–11.

³⁰ Tran-Nam et al, above n 16, 233.

³¹ Ibid.

³² Sandford, Godwin and Hardwick, above n 5, 13.

³³ Ibid.

the type of tax involved, the time lag between the receipt of the income and the payment of the tax, the use made of cash flow benefits and the interest rate.³⁴

The type of tax (direct or indirect), the design of the tax and the business cycle will determine when the amount of tax is collected and when it is paid.³⁵ This can be illustrated by the example of the Australian GST. The time lag and hence the size of the cash flow benefit derived from complying with GST will be dependent on the following determinants: the basis used for accounting for GST (cash or accrual); the periodicity of the GST return (monthly or quarterly); the delays in obtaining payment from customers; the delay in sending payment to suppliers.

Interest rates should be chosen with reference to some interest rate benchmark and to the use that will be made of the available cash.³⁶ For many small businesses with a bank overdraft, the overdraft rate (usually high) may be used as the reference rate.³⁷

F *Managerial Benefits*

Managerial benefits have already been introduced and are discussed in further detail later in this paper. At this stage, it can be said of managerial benefits that they arise because, as a result of tax compliance, businesses keep better accounting records and use these records for improved decision-making.³⁸ Even though the concept is straightforward, managerial benefits are, of their nature, elusive and their identification and their quantification pose problems.³⁹ According to Tran-Nam, this is the main reason why managerial benefits were generally ignored by researchers in their evaluation of net compliance costs.⁴⁰

III THE COSTS OF COMPLYING WITH TAX FOR SMALL BUSINESS

A *The Magnitude of Tax Compliance Costs: International Comparisons*

The evaluation of tax compliance costs has been the object of numerous studies and the overall findings are that tax compliance costs are large and that they fall disproportionately on small business taxpayers.⁴¹

The most recent comprehensive survey of tax compliance costs for business taxpayers in Australia was conducted in 1994–95. The research findings show an average compliance cost per business taxpayer of \$1898 (after deduction of tax deductibility benefits and cash flow benefits). Expressed as a per centage of tax revenue, net tax compliance costs of all Australian business taxpayers represented 9.4 per cent of total tax revenue.⁴²

Although international comparisons can help evaluate the relative importance of Australian findings, the different nature of the surveys make the interpretation of research outcomes very difficult.⁴³ The survey of New Zealand businesses in 1990–91 is probably one of the best benchmarks available. Expressed as a per centage of GDP,⁴⁴ the aggregate compliance was

³⁴ C Evans et al, 'A report into taxpayer costs of compliance' (Australian Taxation Office, 1997) Evans et al, *A Report into Taxpayer Costs of Compliance* (Australian Taxation Office, 1997) 14–15., 14–15.

³⁵ Sandford, Godwin and Hardwick, above n 5, 39.

³⁶ Evans et al., *A report into taxpayer costs of compliance*, above n 34, 13.

³⁷ Sandford and Hasseldine, above n 4, 11.

³⁸ Ibid 7.

³⁹ Sandford et al, above n 6.

⁴⁰ Tran-Nam, above n 9.

⁴¹ Sandford, 'The Rise and Rise of Tax Compliance Costs', above n 12, 5.

⁴² Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 53.

⁴³ Ibid 72–3.

⁴⁴ Because taxes in different countries are applied with different tax rates, ratios of tax compliance costs to GDP are more meaningful than ratios relative to tax revenue.

estimated at 2.5 per cent of the New Zealand GDP,⁴⁵ compared with social costs of tax compliance (before tax deductibility benefits and cash flow benefits) representing 1.95 per cent of GDP in Australia in 1994-95.⁴⁶

A few authors have commented on the inconsistencies that exist between different studies. For instance, Wallschutzky and Gibson concluded from their case study of 12 Australian businesses that compliance costs did not constitute a first order problem for small businesses.⁴⁷ Similarly, Pope's estimate of compliance costs with company tax in Australia was five times higher than Sandford's estimate of the compliance costs with the UK corporate tax.⁴⁸ However, these discrepancies have generally been attributed to conceptual and methodological problems which are beyond the scope of the present paper.

B *The Regressive Nature of Tax Compliance Costs*

The regressive nature of tax compliance costs was first identified by Bryden and has since been confirmed by a number of other studies both in Australia⁴⁹ and internationally.⁵⁰ The results of the Australian study are presented below. Table 1⁵¹ presents the estimated average tax compliance costs for Australian business taxpayers classified by firm size, while Table 2⁵² shows average tax compliance costs by size categories expressed as a per centage of turnover. The categories used for firm size were consistent with ATO annual turnover classifications: 'small' meaning turnover less than \$100 000; 'medium' meaning turnover between \$100 000 and \$9.99 million; and 'large' meaning turnover of \$10 million and over.

Table 1: Estimated Average Compliance Costs of Australian Business Taxpayers by Business Size 1994-95

	All Firms	Small*	Medium*	Large*
Social Costs of Compliance	\$3,624	\$1,707	\$8,784	\$91,864
Tax Deductibility Benefits	(\$999)	(\$358)	(\$2834)	(\$24,995)
Cash Flow Benefits	(\$727)	(\$113)	(\$1,016)	(\$96,963)
Net Compliance Costs	\$1,898	\$1,235	\$4,935	(\$30,052)

Table 2: Estimated Average Compliance Costs of Australian Business Taxpayers as a Per centage of Turnover by Business Size 1994-95

	Small	Medium	Large
Social Costs of Compliance	3.41 per cent	0.17 per cent	0.18 per cent
Net Compliance Cost	2.47 per cent	0.1 per cent	(0.06 per cent)

The figures indicate that regressivity was more accentuated after deduction of compliance benefits, particularly cash flow benefits. While small firms had average net compliance costs of

⁴⁵ J Hasseldine, 'Compliance costs of business taxes in New Zealand' in C Sandford (ed), *Tax compliance costs measurement and policy* (1995).

⁴⁶ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 53.

⁴⁷ I Wallschutzky and B Gibson, 'Small business cost of tax compliance' (1993) 10 *Australian Tax Forum* 511.

⁴⁸ S Stephen Rimmer and Stuart Wilson, 'Compliance costs of taxation in Australia' (Office of Regulation Review, 1996).

⁴⁹ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34.

⁵⁰ See Sandford, Godwin and Hardwick, above n 5, p 28-9.

⁵¹ *Ibid* 52.

⁵² *Ibid* 79, 81.

\$1235, the estimate was \$4935 for medium firms. Large firms obtained an average net benefit of \$30 000 from complying with their tax obligations.⁵³ Gross compliance costs or the social cost of compliance represented 3.41 per cent of the turnover of small businesses but only 0.18 per cent of the turnover of large businesses. Further, net compliance costs for small businesses were equal to 2.47 per cent of turnover but only 0.1 per cent of turnover for the medium size category.

These results were broadly consistent with outcomes from earlier surveys. Average gross tax compliance costs for UK businesses in 1986–87 were found to represent 3.66 per cent of turnover for businesses in the less than £100 000 (A\$238 000) category, 0.62 per cent in the £100 000 to £1m (A\$2.38 million) category and 0.17 per cent in the over £1 million group.⁵⁴ Mean gross compliance costs for New Zealand businesses surveyed in 1990–91 ranged from 6.5 per cent of turnover for businesses with an annual turnover between NZ\$30 000 (A\$27 900) and NZ\$100 000 (A\$93 000) to 0.03 per cent for firms with an annual turnover over NZ\$50 million (A\$46.5 million).⁵⁵

In the US, a survey of regulatory costs conducted by the Office of Advocacy revealed average tax compliance costs for all firms to be equivalent to US\$665 (A\$899) per employee.⁵⁶ Broken down by firm size, the cost per employee was US\$1202 (A\$1624) for firms with less than 20 employees, US\$625 (A\$845) for firms having between 20 and 499 employees and US\$562 (A\$759) for firms employing more than 500 people.

The above results obtained from large scale surveys undertaken in four different countries confirm the assumption that tax compliance costs are highly regressive with respect to firm size, with a compliance burden (expressed as a per centage of turnover) being on average twenty times heavier for small firms than it is for large firms. However, as the research from the US indicates, the regressivity seems to be less accentuated when size is measured in terms of number of employees.

C *The Costs of Complying with Specific Taxes*

As highlighted previously, the Australian study was one of the few studies that analysed overall compliance costs for all taxes,⁵⁷ notwithstanding that most tax compliance costs research in Australia has measured the cost of complying with specific taxes: personal income tax, employment taxes, corporation tax and others.⁵⁸ GST has been the tax that has attracted by far the greatest interest, probably because it affects a large number of small business taxpayers and because it is expected that the transaction-based nature of GST/VAT will generate high compliance costs. The focus of GST studies in Australia has been on the start-up costs associated with the new tax.⁵⁹ Average start-up costs of GST for small business have been estimated

⁵³ At the time of this survey, GST was not applicable in Australia. Instead, some businesses had to comply with the Wholesale Sales Tax legislation which had a far more limited application. Considering the compliance costs associated with GST (see below), it is expected that if the survey were undertaken 10 years later, the average net compliance costs would have been significantly higher.

⁵⁴ Sandford, Godwin and Hardwick, above n 5, 199.

⁵⁵ Sandford and Hasseldine, above n 4, 108.

⁵⁶ The evaluation of Tax compliance costs relies on the method adopted by the Tax Foundation. W. M. Crain and T. D. Hopkins, 'The impact of regulatory costs on small firms' (The Office of Advocacy, US Small Business Administration, 2001).

⁵⁷ See also M Allers, Maarten Allers, *Administrative and compliance costs of taxation and public transfers in the Netherlands* (1994) which looked concurrently at all business taxes in the Netherlands.

⁵⁸ See extensive studies by Pope in this area: Pope, Fayle and Duncason, J Pope, R Fayle and M Duncason, *The compliance costs of Personal Income Taxation in Australia 1986-87* (1990) above n 22; J. Pope, R. Fayle and D. Chen, *The compliance costs of employment related taxation in Australia* (1993); J. Pope, R. Fayle and D. Chen, *The compliance costs of Wholesale Sales Tax in Australia*, Australian Tax Research Foundation (1993); J Pope, R Fayle and D Chen, *The compliance costs of companies' Income Tax in Australia* (1994).

⁵⁹ GST was introduced in Australia on 1 July 2000.

between \$5000 and \$7000.⁶⁰ More recently, a case study of 53 Australian SMEs evaluated the recurrent costs of complying with GST at \$2481 (gross compliance costs), but the compliance burden was reduced to \$1244 after taking into account tax deductibility benefits and cash flow benefits.⁶¹

Other taxes being considered were employment taxes and company tax. The main features of compliance costs relating to employment taxes were that internal costs, particularly time costs, constituted almost 90 per cent of overall compliance costs, and that the number of employees was the main driver of costs.⁶² However the ratio of compliance costs to tax remitted was found to decrease as the amount of tax remitted increased.⁶³

The cost of complying with company tax has been examined in several countries, yet only two studies, one in the UK and one in Australia included small companies. In both cases, compliance costs of corporate taxes were found to be highly regressive.⁶⁴

The investigation of compliance costs and administrative costs associated with a particular tax provides information that is of obvious interest to policy makers and the tax authorities. However as noted by Sandford,⁶⁵ looking concurrently at different taxes avoids the problem of allocating joint costs to different taxes where there are often too interrelated to be successfully examined in isolation. On the other hand, a comprehensive study of all taxes also raises the danger of double-counting as taxpayers may inadvertently allocate the same compliance cost to more than one tax activity.⁶⁶

D Factors Influencing Tax Compliance Costs

Several factors are considered to be potential determinants of tax compliance costs of business taxpayers; these include size, legal form and industry sector.

Even though the analysis by business size seems to be a feature of many tax compliance costs surveys, size was not always measured in the same way. Turnover is the most commonly adopted measure, however number of employees, amount of tax paid or asset size have also been used.⁶⁷ It is worth considering that particular measures might be better suited to predicting the compliance costs of specific taxes. For instance, the number of employees is found to be a determining factor of the compliance costs of employment taxes.⁶⁸ The compliance costs of other taxes such as VAT/GST, income tax and corporation tax have often been analysed according to

⁶⁰ See B Binh Tran-Nam and J Glover, 'Estimating the transitional compliance costs of the GST in Australia' (2002) 17(4) *Australian Tax Forum* 499.

⁶¹ Binh Tran-Nam, John Glover and Sarah Wilkin, 'The GST recurrent compliance costs/ benefits of small business in Australia: A case study approach' (Paper presented at the 16th Annual Australasian Tax Teachers Association, Adelaide, 2004).

⁶² Sandford, Godwin and Hardwick, above n 5.

⁶³ Pope, Fayle and Chen, [The compliance costs of employment related taxation in Australia], above n 56.

⁶⁴ Compliance costs of company tax for UK companies in 1989 expressed as a per centage of annual turnover ranged from 0.77 per cent for small companies (TO < £50,000) to 0.01 per cent for large companies (TO > £10m): Sandford, Godwin and Hardwick, above n 5, 142. The mean compliance costs for all Australian companies in 1994 represented 1.4 per cent of annual turnover. However, the mean compliance costs for small companies (TO < \$500,000) was found to be equivalent to 4 per cent of annual turnover: Pope, Fayle and Chen, [The compliance costs of companies income tax above n 56, 62-3.

⁶⁵ Sandford, *Improving the Methodologies*, above n 3, 404.

⁶⁶ Telephone interview with C Evans, 27 September 2005.

⁶⁷ For studies using turnover, see Sandford, Godwin and Hardwick, above n 5; Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4. For studies using number of employees, see Sandford and Hasseldine, above n 4. For studies using amount of tax paid, see Pope, Fayle and Chen, [The compliance costs of employment related taxation], above n 56. For studies using asset size, see J Slemrod and V Venkatesh, J. Slemrod and V. Venkatesh, 'The Income tax compliance cost of large and Mid-size businesses' (University of Michigan Business School, 2002).

⁶⁸ Sandford and Hasseldine, above n 4.

the level of turnover, however studies carried out in the US suggest that firms with more assets incur greater compliance costs⁶⁹.

An analysis by entity type has also been carried out in Australia. Noting the clear correlation between entity type and the size of the business,⁷⁰ the size variable should be neutralised before measuring the influence of the legal form factor. A breakdown of the average social compliance costs after tax deductions by legal form for firms in the 'small' category revealed that trusts had the highest compliance costs (\$55.34 per \$1000 of turnover) while sole traders had the lowest (\$21.10 per \$1000 of turnover).⁷¹ The same study also considered business industry type as a variable. There is also evidence of a correlation between size and industry type which makes any interpretation of the outcomes very difficult.⁷²

Following their study of medium and large businesses in the US, Slemrod and Venkatesh presented useful two-dimensional analyses of their results.⁷³ A breakdown by asset size and type of form filed shows that in the US\$5 million to US\$10 million (A\$6.8 million to A\$13.5 million) asset size category, corporations and partnerships had almost the same level of compliance costs.⁷⁴ For all asset size categories over US\$10 million, corporations had higher compliance costs than partnerships. The analysis by industry shows that firms in the 'communications, technology and media' sector have the highest compliance costs in the US\$5 million to US\$10 million band, but in the next band — US\$10 million to US\$50 million (A\$13.5 million to A\$67.5 million) — the 'retail, food and healthcare' sector had the highest compliance costs.⁷⁵

While most tax compliance cost research is primarily descriptive, a few studies have attempted to build causal models of tax compliance costs. Beale and Lin, for instance, proposed a classification of the tax compliance costs of small businesses into three categories: costs that can be considered as fixed independently of business size (eg, learning about tax requirements), costs that do vary proportionately with size (eg, organising data and records for tax preparation) and costs that will not be avoided where they are too small to justify the expense of preventing these costs (eg, contesting erroneous assessment).⁷⁶ Beale and Lin claimed that the tax compliance burden does not vary smoothly with size but drops once some thresholds such as computerisation and access to specialised tax expertise are passed.⁷⁷

More recently, in the UK, Hasseldine and Hansford surveyed a large sample consisting of businesses of different sizes and from different industry sectors.⁷⁸ They used regression analysis to test the influence of eight determinants on the cost of compliance of VAT. They concluded that size (expressed as turnover), industry sector, use of computerised system, use of external

⁶⁹ See Slemrod and Venkatesh, above n 67.

⁷⁰ According to the study, 80.3 per cent of sole traders were small businesses (turnover < \$100,000), while 40.1 per cent of companies and 59.5 per cent of trusts belonged to that category: see Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 136.

⁷¹ Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 80.

⁷² For instance 58.6 per cent of construction businesses were small and 28.8 per cent of wholesale trade businesses were small: see Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 166.

⁷³ Slemrod and Venkatesh, above n 67.

⁷⁴ The average compliance costs were US\$24 864 for entities lodging a 1120 Form (corporations) and US\$25 467 for entities lodging a 1065 Form (partnership). Corporations qualifying for the special 'pass-through' tax treatment (Form 1120S) had much higher compliance costs of US\$48 750: see *ibid*, 42.

⁷⁵ See Slemrod and Venkatesh, above n 67, 43. The author notes that the number of observations in each cell for the 'less than US\$5 million' band, and in the bands US\$50 million and upwards, were too small to be considered statistically significant.

⁷⁶ H. Beale and K Lin, 'Impacts of federal regulations, paperwork and tax requirements on small business' (Office of the Advocacy of the US Small Business Administration, 1998).

⁷⁷ *Ibid* 282.

⁷⁸ J Hasseldine and A Hansford, 'The compliance burden of the VAT : further evidence from the UK' (2002) 17(4) *Australian Tax Forum* 369.

advisers, level of complexity, and psychological stress were statistically significant determinants of compliance costs.⁷⁹

In summary, the extant research generally supports the perception that the costs of complying with tax are high and regressive, and determined according to size. The costs of compliance were particularly high when associated to transaction based taxes such as GST. The literature also identified a range of factors which besides size could influence the tax compliance costs incurred by business taxpayers. These include legal form, industry, complexity of legislation, computer use and use of an external accountant.

IV THE BENEFITS OF COMPLYING WITH TAX FOR SMALL BUSINESSES

Several types of tax compliance benefits have been identified earlier in this paper. They are tax deductibility benefits, cash flow benefits and managerial benefits. Most authors include tax deductibility benefits and cash flow benefits to arrive at net compliance costs. As shown in Table 1 earlier in the paper, the average tax deductibility benefit (\$358) and cash flow benefit (\$113) for small Australian businesses in 1994–95 were not inconsiderable. However, it is argued in this paper that many small businesses could be deriving potentially higher ‘managerial benefits’ as a result of engaging in tax compliance activities. As managerial benefits are potentially significant, but have generally been omitted from most studies, the emphasis here will be on this type of benefit.

A The Concept of Managerial Benefit

Sandford contended that the effect of complying with tax may not always be detrimental, as individuals who complete their tax return and file the necessary information to do so, may at the same time be encouraged to engage in more efficient management of their financial affairs. These managerial benefits are likely to be more significant in the case of businesses as compliance with the tax system will force the business owner to introduce a more efficient financial information system.⁸⁰ Managerial benefits had been previously identified and estimated by Sandford in his 1981 study of the compliance costs of VAT in the UK.⁸¹ In the same publication, Sandford described managerial benefits as follows:

It is clear that there are continuing and not inconsiderable cash benefits from the better record keeping which is necessary to comply with VAT requirements. It is not possible to put a realistic value on these benefits but they are an important offset to the compliance costs of some of the smaller businesses.⁸²

Tran-Nam offered a broader definition a few years later, suggesting that ‘[m]anagerial benefits come in the form of improved decision-making brought about by the need to have more stringent record keeping in order to comply with the requirements of tax law.’⁸³

Key elements in these two definitions should be noted. First, managerial benefits theoretically arise because the better quality of the financial information will be the basis for improved decision-making. Second, managerial benefits are likely to be significant, particularly in the case of small businesses. Third, managerial benefits are difficult to value. In these definitions, better record keeping is identified as the main source of managerial benefits. Yet, record keeping is a

⁷⁹ Ibid 380–2.

⁸⁰ Sandford, Godwin and Hardwick, above n 5, 13.

⁸¹ Sandford et al, above n 6.

⁸² Ibid 118.

⁸³ Tran-Nam, above n 9.

broad concept which encompasses a number of varied and multifaceted activities from which businesses may be able to derive specific forms of managerial benefits. These are now examined.

B *Different Forms of Managerial Benefits*

The different forms of managerial benefits identified by Sandford can be classified into three main categories: benefits generated from improvements to the information system, benefits arising from improvements to controls, and benefits derived from savings on other costs. This section considers each of these categories.

1 *Improved Information System*

The improved information system comes with the necessity to have a complete accounting system where all transactions are recorded. Compliance with VAT or GST, for instance, requires taxpayers to keep a record of their sales and purchases. In the UK, it was found that 32 per cent of respondents thought they had better kept purchase records and 26 per cent had better kept sales record since the introduction of VAT.⁸⁴ The per centages for smaller firms with a turnover under £100 000 per annum (A\$238 000) were 42 per cent and 34 per cent respectively, indicating a clearer perception of improvement among SME owners. In Australia, 73 per cent of small businesses owners expressed the view that compliance obligations acted as an incentive to keep up-to-date records and that the financial report produced from the record keeping system helped them manage the business.⁸⁵ Another survey of Australian small business taxpayers carried out in 2004 revealed generally good record keeping practices.⁸⁶ The primary reason given for maintaining these good quality records was for tax purposes.⁸⁷

In recent years, increasing tax compliance obligations have also been a major driver of the acquisition of computerised information systems ('CIS') by SMEs. Significant computer costs were typically incurred by small firms when a new tax was introduced or when substantial amendments were brought to an existing tax.⁸⁸ In Australia, small business owners interviewed prior to the introduction of GST in 2000,⁸⁹ stated that the new tax was the main reason for acquiring a computer. This acquisition of information technology was actively encouraged by the federal government through the provision of a grant and the possibility of immediate tax deduction.⁹⁰ Computer costs induced by changes in the tax legislation included the acquisition and updating of hardware and software, the modification of accounting and business systems and training of personnel.⁹¹ Small businesses in Western Australia spent an average \$3141 on new equipment and \$2536 on equipment upgrade to comply with the new GST.⁹²

However, computer related expenditures were by no means limited to tax changes. Many small businesses acquired a computer simply because they had to keep financial records for the tax

⁸⁴ Sandford et al, above n 6, 90.

⁸⁵ CPA Australia, 'Small Business Survey Program : Compliance burden' (CPA Australia, 2003).

⁸⁶ C Evans , S Carlon and D Massey, 'Record keeping: Its effect on tax compliance' (CPA Australia, 2005).

⁸⁷ Ibid 8.

⁸⁸ G Bannock and H Albach, *The compliance costs of VAT for smaller firms in Britain and Germany* (1987); CFSUB, 'The tax compliance costs for employers of PAYE and National Insurance in 1995-96' (1998); J Pope, 'Research Methodology for estimating the compliance costs of GST' in A Lymer and D Salter (eds), *Contemporary issues in taxation research* (2003).

⁸⁹ Pope, above n 88, 75-6.

⁹⁰ Ibid.

⁹¹ Tran-Nam and Glover, above n 60; Evans, Carlon and Massey, above n 86.

⁹² N Rametse and J Pope, 'Start-up compliance costs of the GST : empirical evidence from Western Australian small businesses' (2002) 17(4) *Australian Tax Forum* 407.

authorities.⁹³ For example, it was reported that in 1994–95, a period with few significant tax changes in Australia, small business taxpayers spent an average \$458 in modifying tax software, while the average cost for medium sized businesses was \$1670.⁹⁴

These technological changes were likely to generate benefits for the business managers in the form of up-to-date, easily available financial information.⁹⁵ Researchers, who carried out a case study of Australian businesses over three financial years (2000–2003) after the introduction of GST, report numerous instances of business taxpayers deriving managerial benefits from the use of computerised record keeping.⁹⁶ For instance, participants declared that the use of computers gave them instant information about their income and expenses, allowed for analysing, testing and using ‘what if’ scenarios and made application for finance easier as they could provide the bank with adequate financial information.⁹⁷

2 *Improved Controls*

Better control mechanisms will often be associated with the adoption of more sophisticated accounting systems. These improved controls will assist small businesses in three main areas of financial management: cash flow monitoring, stock control and credit management.

Even though business operations are the major sources of cash inflows and outflows, in many jurisdictions the requirements of the taxation system are also likely to have a significant influence on the cash flows of small firms. In Australia, two examples of such influence are provided by the compliance with GST and the compliance with the Pay-As-You-Go (‘PAYG’) system. Compliance with GST forces small firms to keep a record of when they receive GST from their customers, when they pay GST to their suppliers and when they have to disburse the difference to the ATO.⁹⁸ Under the PAYG system, small firms must remit instalment amounts based on their estimated income to the ATO. In most cases, this will require a good element of cash forecasting as for many businesses, profits are taxed when they are earned, not when they are received. No empirical evidence is available to confirm the existence and the magnitude of managerial benefits represented by improved cash flow monitoring. However, a clear majority of Australian Certified Practising Accountants (61 per cent) saw a strong relationship between good quality record keeping and improved cash flow management.⁹⁹

Sandford also expected that more stringent record keeping would lead to improved stock control.¹⁰⁰ This form of managerial benefits does not appear to be commonly perceived by business taxpayers themselves. Only 8 per cent of UK business taxpayers and 12.6 per cent of New Zealand taxpayers agreed that improved stock control was a benefit of complying with VAT or GST.¹⁰¹ However, it is important to point out that these surveys were conducted some time ago, when computerisation was not very widespread among small businesses. Different outcomes may be obtained if a survey was carried out today. It is not unusual for small businesses to acquire integrated accounting systems where the stock management function is linked with the accounting function and sometimes a tax reporting function, such as the preparation of the Business Activity Statement.

⁹³ Scott Holmes and Des Nicholls, ‘Modelling the accounting information requirements of small businesses’ (1989) 19(74) *Accounting and Business Research* 143; R Jarvis, J Kitching and J Curran, *The financial management of small firms: an alternative perspective* (1996).

⁹⁴ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 115.

⁹⁵ Pope, above n 88.

⁹⁶ Tran-Nam, Glover and Wilkin, above n 61.

⁹⁷ *Ibid* 12–3.

⁹⁸ This will be the case for businesses which account for their GST on a cash basis.

⁹⁹ Evans, Carlon and Massey, above n 86, 12.

¹⁰⁰ See Sandford et al, above n 6, 93.

¹⁰¹ *Ibid* 92. Sandford and Hasseldine, above n 4, 77.

In many respects, record keeping associated with tax compliance will be an incentive to develop credit management routines. For example, a comprehensive and up-to-date record of purchases will allow the business to claim discounts more frequently. Likewise, a well kept sales transaction ledger will make it easier to follow customer payments and reduce losses from bad debts.¹⁰² Earlier empirical evidence seemed to indicate that not all SME owner-managers perceived that tax compliance would help them improve their credit management practices.¹⁰³ However, a majority of Australian SMEs surveyed in 2004 had in-house computer-based record keeping systems and in almost all cases, a record of invoices was a feature of that system.¹⁰⁴ Most off-the-shelf accounting packages, such as 'MYOB' and 'Quickbooks' include subsidiary ledgers of debtors and creditors and allow the user to produce an Aged Debtors Trial Balance or an Aged Creditors Trial Balance with minimal effort. These documents may be used by the owner-managers to carry out frequent reviews of the business credit situation.

Notwithstanding the above benefits, it could be argued that some particular aspects of tax accounting may discourage taxpayers from engaging in financial control practices. For instance, the Simplified Tax System ('STS') in Australia encourages business owners to adopt cash accounting and to pool their assets to calculate depreciation. STS also allows taxpayers not to carry out regular stock takes.¹⁰⁵

Overall, although it could be expected that some aspects of tax compliance obligations would be an incentive for small businesses to improve their management controls, there is little evidence that it is actually the case. On the other hand, the acquisition of information technology, driven by increasing tax compliance obligations, seems to be facilitating the implementation of systematic financial control practices.

3 *Savings on Other Costs*

Sandford also suggested that record keeping activities generated by tax compliance may result in savings on external accountant fees and audit fees for the taxpayer.¹⁰⁶ He identified a second potential source of cost savings in the form of a reduction in other compliance costs.¹⁰⁷ Strictly speaking, savings on other costs do not constitute managerial benefits as they do not result in additional information that will lead to better business decisions. However, since the costs associated with hiring an external accountant are essentially related to the acquisition of accounting or managerial information, it can be contended that savings on these costs constitute a managerial benefit. It is arguably more difficult to justify the inclusion of savings on other compliance costs as managerial benefits. One possible justification is that like other types of managerial benefits, savings on other compliance costs are induced by the improved record keeping and better-quality financial information. Savings on accountant fees, then savings on other compliance costs are discussed in this section.

Where tax compliance encourages taxpayers to prepare their accounts internally or to do their own bookkeeping, there will be potential savings on accountant fees and audit fees. They may not require an external accountant, or if they do, they may save at least on accountant time.¹⁰⁸

¹⁰² Sandford et al, above n 6, 92.

¹⁰³ See Sandford and Hasseldine, above n 4. The survey asked small business taxpayers which benefits they were deriving from better record keeping and knowledge of finances forced by the introduction of GST. Almost half of respondents (47.4 per cent) agreed that they derived a benefit because purchase records were better kept. Only 39.6 per cent agreed that they were benefiting from better kept sales records.

¹⁰⁴ Evans, Carlon and Massey, above n 86.

¹⁰⁵ Paul Kenny, 'A 'Simplified Tax System' for small business' (2002) 6(1) *The Tax Specialist* 36.

¹⁰⁶ Sandford et al, above n 6.

¹⁰⁷ *Ibid.*

¹⁰⁸ Sandford et al, above n 6.

This proposition assumes that the taxpayer would prepare and keep accounts even if taxes were eliminated. In Australia, only a handful of small proprietary companies are required to prepare external financial reports. It has been noted, for example, that 81.5 per cent of small Australian businesses and 69 per cent of medium businesses use financial statements mainly for tax calculation.¹⁰⁹

The accountant fee saving hypothesis receives little support from existing empirical evidence. Only 25 per cent of respondents to a 1981 survey claimed that they saved money by doing their own accounts as a result of complying with VAT requirements. The percentage was higher (36 per cent) among firms with a turnover under £10 000 (A\$23 800).¹¹⁰ More recently in Australia, Evans, Carlon and Massey used a sample of small Australian SMEs to investigate the relationship between quality of record keeping and fees paid to external accountants.¹¹¹ Contrary to their predictions, they found that businesses with better record keeping practices actually appeared to be paying higher external fees.¹¹² The authors explained this unanticipated result as follows: small firms who invest money and time to support a quality internal information system may also be prepared to incur the costs of engaging quality external professionals.

However, savings on accountant fees may also be realised because small businesses are obtaining services from their external advisers for which they would otherwise have to pay, had they not hired an accountant for tax reasons. Empirical evidence indicates that many accountants or other tax advisers were providing a variety of business services that were incidental to tax related activities. In Australia, accountants often completed compliance tasks other than tax, such as company law obligations, workers compensation and other regulatory requirements.¹¹³ They were also preparing the financial reports required by credit providers or other stakeholders, and were often an important source of advice in the selection and installation of computer software.¹¹⁴ In addition, business clients often received general business advice, or advice regarding their personal tax affairs, superannuation and insurance matters.¹¹⁵

Even where accounting practitioners charged their clients for these additional services, it is reasonable to expect that the fees would have been higher if the services had been provided separately from tax compliance activities. The main reason for this is that the accountant will be able to perform different tasks for the same client with increased productivity. Economies will be achieved because in most cases a common base of information (accounting records) is used to provide different services, and also because the practitioner is familiar with the client's situation.

Sandford also made the suggestion that business taxpayers who keep high quality records will, as a direct or indirect consequence, save on their overall tax compliance costs.¹¹⁶ There will be direct savings because better records will make other tax compliance tasks easier and consequently less costly. Small business taxpayers may also realise indirect savings on their tax compliance costs because firms with better records are less likely to be targeted for a tax audit.¹¹⁷ Furthermore, firms with better records which *are* audited are less likely to receive an amended

¹⁰⁹ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4, 116.

¹¹⁰ Sandford et al, above n 6, 92.

¹¹¹ Evans, Carlon and Massey, above n 86.

¹¹² *Ibid* 11.

¹¹³ An example of this is the financial report for businesses in the construction industry required by the Building Services Authority in many Australian states. Another example is the audit of trust accounts required by the legislation governing real estate agents. See CPA Australia, above n 85.

¹¹⁴ Evans Carlon and Massey, above n 86.

¹¹⁵ CPA Australia, above n 85; Matthew Gorton, 'Use of financial management techniques in the U.K.-based small and medium sized enterprises: Empirical research findings' (1999) 12(1) *Journal of Financial Management & Analysis* 56

¹¹⁶ Sandford et al, above n 6.

¹¹⁷ Evans, Carlon and Massey, above n 86, 10.

assessment.¹¹⁸ When these hypotheses were tested, the results could not conclusively establish that improved record keeping would lead to direct or indirect savings on tax compliance costs. The only proposition that received some support was that the preparation of accounting records would reduce the likelihood of taxpayers receiving an amended assessment.¹¹⁹

In conclusion, the empirical evidence on managerial benefits derived as a result of cost savings is rather unconvincing at this stage. There is some indication that many small businesses are obtaining additional value from accounting practitioners in the form of incidental services, however the extent to which this represents a significant cost saving for the client needs to be ascertained by further research. Likewise, additional evidence is required to establish whether business taxpayers with a high quality record keeping system, will as a result derive a benefit in the form of a reduction of exposure to tax audit and adverse audit outcome.

C Evidence of the Importance of Managerial Benefits

So far, only two studies in the UK have attempted to quantify managerial benefits¹²⁰. Both studies relied on the subjective estimates given by owner-managers for the benefits they received. In the 1981 Sandford study, respondents were asked to attribute values to specific managerial benefits, while the 1994 study presented an overall estimation of managerial benefits.

The report from the National Audit Office valued managerial benefits induced by compliance with VAT at £149 million (A\$355 million), representing 9 per cent of gross tax compliance costs (Table 3). The importance of managerial benefits relative to gross tax compliance costs ranged from 28 per cent for businesses with a turnover of £19 000 (A\$45 000) or less to 7.4 per cent for business in the £100 000 to £500 000 (A\$238 000 to A\$1.19 million) category.

The outcome of this survey reveals that managerial benefits derived by small businesses are roughly three times as large as those derived by medium and large firms. This confirms the prediction made by Sandford, Evans and others that managerial benefits will be relatively larger in the case of smaller businesses.¹²¹ While many large firms have to prepare external accounts under the *Corporations Act* (public companies and large proprietary companies in Australia), most SMEs have no reporting obligations and therefore are likely to obtain a benefit from the additional financial information generated by a more rigorous record keeping.

The results from the National Audit Office survey also corroborate earlier findings that the number of benefits from complying with VAT was higher for small business owners.¹²² The earlier 1981 study asked business owners to state the number of benefits which they thought they received as a result of complying with VAT. The data collected was then analysed by firm size category and industry sector. As a correlation exists between size and industry sector, it is necessary to neutralise the size effect by only including responses from small businesses (turnover under £20 000 (A\$47 600)).

¹¹⁸ Ibid.

¹¹⁹ Ibid.

¹²⁰ See Sandford et al, above n 6; National Audit Office, 'HM Customs and Excise : Cost to business of complying with VAT requirements' (Her Majesty Stationery Office, 1994)[The report published by the National Audit Office in 1994 largely relied on the valuation undertaken by Sandford.

¹²¹ See Sandford, Godwin and Hardwick, above n 5; Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4; Tran-Nam, above n 9, 55.

¹²² Sandford et al, above n 6, 94.

Table 3: VAT Traders' Managerial Benefits, UK, 1992–93¹²³

Taxable Turnover (per annum)	Gross Compliance costs (GCC) (£m)	Value of managerial benefits (MB) (£m)	Per centage (MB/ GCC)
0-£19,000	14	4	28 per cent
£19,000-£50,000	149	17	11.5 per cent
£50,000-£100,000	199	21	10.5 per cent
£100,000-£500,000	709	53	7.4 per cent
Over £500,000	518	49	9.4 per cent
Total	1589	144	9 per cent

Table 4 presents the per centage of small businesses by industry sector claiming a particular number of benefits. Overall, 60 per cent of respondents claimed that they received at least one benefit from complying with VAT. The transport and communications sector was the sector where respondents were most likely to perceive at least one benefit, while respondents in finance and business services were the most likely to claim they were receiving no benefit at all. Bearing in mind that these benefits include 'extra cash', it is probable that this cash benefit will be the most easily perceived. For this reason, evidence that managerial benefits are perceived is more likely to be found among those traders claiming a high number of benefits. Approximately 30 per cent of businesses in the primary sector claimed they received three or more benefits, while only 12 per cent of firms in the transport and communication sector had the same claim.

Table 4: Per centage of Small Business Taxpayers* Claiming Particular Number of Benefits (Including Cash Flow Benefits) from Complying with VAT, UK, 1977–78¹²⁴

No of Benefits	Sector of Activity									
	Primary (per cent)	Manufacture and Utilities (per cent)	Construction (per cent)	Transport and Communication (per cent)	Retail (per cent)	Wholesale (per cent)	Finance and Business Services (per cent)	Professional and Scientific Services (per cent)	Miscellaneous Public Services (per cent)	All Sectors (per cent)
0	31	51	33	28	50	50	56	41	29	40
1	16	13	25	28	15	20	21	22	15	20
2	22	18	13	31	13	17	9	17	10	17
3	14	15	13	0	13	12	3	7	8	11
4	11	0	13	3	5	0	6	5	3	7
>4	5	3	3	9	4	0	6	8	2	4
Total	100	100	100	100	10	10	100	100	100	10
					0	0				0

* Small business taxpayers defined as having an annual taxable turnover < £20,000

† Percentages may not add up to 100 per cent because of rounding.

¹²³ National Audit Office, above n 120, 20.

¹²⁴ Ibid 235-9.

Other empirical evidence on the existence of managerial benefits for business taxpayers was collected by researchers in New Zealand and Australia. Business owners surveyed in New Zealand were asked whether they agreed with a number of statements regarding benefits derived as a result of complying with GST obligations. Nearly 50 per cent agreed that their purchase records were better kept, 30.9 per cent said that there was useful cash collected but only 7.4 per cent concurred with the statement that the management of their debtors and creditors would be improved.¹²⁵ In a similar study carried out in Australia, a small majority of business taxpayers agreed that the requirements of the federal tax system would help them to improve their record keeping (see Table 5).¹²⁶

In contrast, few respondents in this study perceived that tax compliance requirements would assist them with internal financial management. This was particularly the case of small business taxpayers.¹²⁷ About one third of respondents in that category agreed that the requirements of the federal tax system would improve their knowledge of cash flow and profitability and only 15 per cent concurred with the statement that it did improve their knowledge of stock control.¹²⁸ More recently, Rametse and Pope, studying the impact of the implementation of GST in Australia, reported that only a minority (34 per cent) of respondents thought they would benefit from keeping records for GST purposes.¹²⁹

Table 5: Perception of Australian Business Taxpayers Regarding Benefits of the Federal Tax System¹³⁰

Requirements of the Federal Tax System:	Per centage of Respondents Who Agree or Strongly Agree with the Statement		
	Small* Businesses	Medium* Businesses	Large* Businesses
Improve Record Keeping	50.3 per cent	53.6 per cent	50 per cent
Improve Knowledge of Cash Flow/ Financial Position	34 per cent	37.5 per cent	42.9 per cent
Improves Knowledge of Profitability	36.8 per cent	38.3 per cent	35.7 per cent
Improve Knowledge of Stock Control	15.4 per cent	20.3 per cent	26 per cent

* The classification used by the authors was the ATO classification based on annual turnover: small: <\$100,000, medium: between \$100,000 and \$9.99 million and large: \$10 million and over.

Other surveys of small business taxpayers undertaken in Australia are in apparent disagreement with the above findings. Research commissioned by CPA Australia which interviewed a sample of 701 SME managers across Australia, found 76 per cent of interviewees who stated that they were using financial information produced from the record keeping system to manage the business.¹³¹ Similarly, Evans, Carlon and Massey had 58 per cent of small business respondents consider general business management to be the most important reason for keeping records (against 23 per cent who thought compliance with tax law was the most important reason).¹³²

¹²⁵ Sandford and Hasseldine, above n 4, 76–7.

¹²⁶ Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ Rametse and Pope, above n 92, 434.

¹³⁰ Evans et al, *A report into the incremental costs of taxpayer compliance* above n 4, Table 7.68 to 7.71.

¹³¹ CPA Australia, above n 85, 17.

¹³² Evans, Carlon and Massey, above n 86, 8.

This apparent discrepancy between research outcomes warrants further explanation. First, we can note the different wording of the questions in each survey. In one survey, respondents were required to state their opinion about specific relationships between tax compliance requirements and improved record keeping and other aspects of financial management. This contrasts with the CPA survey, where the question asked was of a general nature and enquired about respondents' overall perceptions. Similarly, in Evans, Carlon and Massey's survey, respondents were required to rank reasons for keeping records. It can be anticipated that different types of questions will be interpreted differently by respondents,¹³³ and caution needs to be exercised when comparing outcomes.

Second, there was a difference in the methods that were used to conduct the surveys. In the earlier study, mailed questionnaires were used, whereas in the latter CPA study, respondents were interviewed by telephone. When comparing large scale mail surveys and interview surveys, Sandford argued that while the quality of information was expected to be higher with an interview survey,¹³⁴ the condition of the interview had a significant impact on the response. In the case of the CPA survey, the number of questions was rather high (23 in total). Moreover, Question Seven had eight different statements about which respondents had to express their agreement or disagreement. It can be anticipated that in these conditions, respondents may be tempted to state their opinion about each statement without taking the time to think it through.

In conclusion, even though the evidence on managerial evidence is extremely patchy, there is some indication that they are recognised by a significant proportion of business owners. Also, there is a perception that the benefits come in the form of improved financial information (notably through the use of a CIS) rather than in the form of improved internal controls, and as mentioned earlier, there is little existing evidence that benefits may come from savings on other costs. Finally, it is worth noting that to this date, there has been no systematic study of managerial benefits from compliance with taxes other than GST/VAT.

V THEORETICAL ISSUES ARISING FROM THE STUDY OF TAX COMPLIANCE COSTS AND BENEFITS

Several researchers have commented on the lack of theoretical coherence of tax compliance costs research. In particular, they have criticized the fact that current research in the area consists mostly of empirical surveys that collect data without any attempt to integrate with other fields of research. James, for example, argues that the findings that tax compliance costs are high and regressive, should be discussed with reference to broader tax policy issues.¹³⁵ He also suggests that more research should address the reasons why compliance costs are so high. Another common criticism concerns the variety of approaches used by researchers to estimate the time spent on compliance activities.¹³⁶

Conceptual issues regarding gross and net compliance costs, avoidable and non-avoidable costs were briefly addressed in the definitions and concepts section. The other theoretical issues which have been discussed in the literature include the measurement of taxpayer's time¹³⁷, the valuation

¹³³ See S Payne (1951) as cited in J J Gill and P Johnson, *Research methods for managers* (3rd ed, 2002).

¹³⁴ Sandford, above n 3, 382–3.

¹³⁵ Simon James, 'Book Reviews : Taxation compliance costs :A Festschrift for Cedric Sandford' [2003] *British Tax Review* 69.

¹³⁶ Rimmer and Wilson, above n 48; J John Turner, Malcolm Smith and J Gurd, 'Recognizing the pitfalls in tax compliance costs research' (1998) 8 *Revenue Law Journal* 62.

¹³⁷ For a full discussion of the valuation of taxpayer compliance time issues, see J Pope, 'The Compliance Costs of Major Taxes in Australia' in C Sandford (ed), *Tax Compliance Costs Measurement and Policy* (1995) 101, 114–9; see also Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 9–12.

of cash flow benefits¹³⁸, the treatment of overhead and the accounting/taxation overlap. Given the focus of this paper on managerial benefits, this section will only consider questions which are directly or indirectly relevant to this particular issue. Such questions include the disentangling of tax and accounting overlap, the question of cost allocation and the problem posed by the measurement of managerial benefits.

A Disentangling Accounting and Tax Related Activities

The problem of how to distinguish between accounting and tax compliance activities and their associated costs translates directly into how to distinguish between accounting-induced and tax-induced managerial benefits.¹³⁹ There are two aspects to the problem of disentanglement.

The first aspect is represented by the fact that many functions or activities conducted within the business, or which have been outsourced to external parties, are performed for several joint purposes. A good example is the presence of payroll records which are maintained for PAYG compliance but are also required by the industrial relation legislation and may be used for costing purposes.¹⁴⁰ Another example is a lease/buy decision where options would be considered from both tax planning and financial management perspectives. One survey of Australian business taxpayers, asked business taxpayers respondents to identify time spent on a list of core accounting activities and time spent on additional record keeping necessary due to tax requirements. On the basis of the results obtained, the researchers considered that they had been able to separate accounting costs from tax compliance costs with some degree of accuracy although they admitted that there were inconsistencies between the response to the question on core accounting activities and subsequent questions.¹⁴¹

The second aspect of the disentanglement problem relates to taxpayer perception of compliance costs. At one extreme, a taxpayer may regard all the costs involved in keeping records and preparing accounts as tax compliance costs because taxation is the only reason he or she recognises for performing these activities. In this situation, any use of the information for a purpose other than tax compliance should be regarded as an offset to compliance costs in the form of a managerial benefit. At the other extreme, tax may be described as no more than a by-product of an ordinary accounting function.¹⁴²

Sandford also argued that the definition of tax compliance costs is a matter of perception and may differ between persons. He illustrates his line of reasoning with the following example:

Consider two university professors A and B, who undertake consultancy work in addition to their main employment. If there were no income tax requirement, A, who wishes to maintain a close check on his financial situation, would keep detailed accounts; B, with no such inclinations, would keep nothing recognisable as accounts, but only records to ensure he was paid for work done. If, then tax is introduced, the tax compliance costs of A would be modest and incremental. Those of B would be the whole of the accounting system he has been obliged to introduce to satisfy the income tax authorities.¹⁴³

This example can be expanded to incorporate the concept of managerial benefits. One might continue Sandford's argument by adding that B, having set up an accounting system, may realise that he has now at his disposal useful information which enables him to keep a close check on his financial situation. While B would be deriving a managerial benefit as a result of being obliged

¹³⁸ For a discussion on the valuation of cash flow benefits, see Evans et al, *A Report into Taxpayer Costs of Compliance*, above n 34, 12–14.

¹³⁹ Tran-Nam, above n 9, 55.

¹⁴⁰ Turner, Smith and Gurd, above n 136, 66.

¹⁴¹ Evans et al, above n 4, 15, 92.

¹⁴² Tran-Nam, above n 9, 57.

¹⁴³ Sandford, above n 3, 394.

to comply with the tax requirements, A on the other hand, would gain no benefit from complying with tax since he was already obtaining the same information before the tax was introduced.

B *The Allocation of Common Costs*

Another problem that emerges as a consequence of the tax/accounting overlap is the allocation of costs which are incurred jointly to perform tax compliance activities and accounting or other business functions. These common costs may come in the form of overhead costs or in the form of the depreciation costs of assets used for a mixed purpose.

Most tax compliance studies have ignored incidental overhead costs because of the difficulty in tracing them to tax compliance tasks.¹⁴⁴ Johnston, who considered such costs, observed that the costs of shared facilities such as office space and lighting are minimal and that, in any case, they should only be taken into account if the elimination of a tax would cause a reduction of these costs.¹⁴⁵

The most common situation where business assets are used for a mixed purpose is where computing equipment is acquired to be used jointly for management and tax compliance purposes.¹⁴⁶ Should the acquisition costs (or depreciation costs) be allocated between tax compliance and financial management on the basis of usage or should 100 per cent be assigned to tax compliance on the ground that the equipment was purchased for the primary reason of tax compliance?

Johnston advocated an 'incremental' approach to solve the problem of common costs. According to this approach, costs that would not have been incurred but for the existence of a tax should be included as tax compliance costs.¹⁴⁷ Following the incremental logic, if computer equipment is acquired for the specific purpose of complying with a new tax, then 100 per cent of its costs should be allocated to tax compliance, even though the equipment is used jointly for management and tax purposes.

The choice of a method for allocating joint costs has important consequences for the valuation of managerial benefits. Under the incremental approach, if the whole cost of acquisition of the computer is allocated as a cost of tax compliance, then a managerial benefit should be recognised to account for any usage other than tax compliance work. On the other hand, if the initial cost of the computer is allocated between tax and accounting, then no managerial benefit need to be recognised to offset the cost of tax compliance.

C *The Measurement of Managerial Benefits*

As noted earlier, the only attempts to quantify managerial benefits were based on subjective evaluations by taxpayers. The controversy surrounding the valuation of taxpayer compliance time costs indicate that relying exclusively on subjective evaluations does not provide a satisfactory measure.¹⁴⁸ In the case of managerial benefits, the valuation appears to be even more

¹⁴⁴ Tran-Nam et al, above n 16, 236.

¹⁴⁵ Johnston, above n 10, 9. An alternative treatment of overhead costs was proposed by Yocum. Yocum argued that for most business organisations, compliance work would increase operating costs and therefore tax compliance costs should include a proportion of overhead costs: J James Yocum, *Retailers' costs of sales tax collection in Ohio* (1961) Sandford's own position on the matter seemed to be very close to Johnston's. He maintained that, where overhead expenditure is independent from taxation; that is, the cost would have been incurred even in the absence of taxation, the overhead compliance costs is zero: Sandford, Godwin and Hardwick, above n 5, 16.

¹⁴⁶ J Pope, 'Factors affecting the compliance cost of the goods and services tax in Australia' in C Evans, J Pope and J Hasseldine (eds), *Tax compliance costs: A festschrift for Cedric Sandford* (2001) 139.

¹⁴⁷ Johnston, above n 10, 8.

¹⁴⁸ For a discussion on the issue of valuation of taxpayers' compliance time, see Pope, 'The Compliance Costs of Major Taxes in Australia', above n 132, 101.

problematic. In the 1981 VAT survey conducted in the UK, only 7.5 per cent among respondents who recognised that they were deriving managerial benefits, gave a positive value to those benefits.¹⁴⁹ This result suggests that whereas business taxpayers would generally be aware that they are receiving managerial benefits from tax compliance, they would not be able to accurately quantify them in dollar terms.

The problem of the measurement of managerial benefits can be expressed in terminology borrowed from the utility theory in economics. Using that theoretical framework, it can be argued that the value of managerial benefits is represented by the marginal utility that can be obtained from using the additional information available to the taxpayer.¹⁵⁰ Transposing the key assumption of diminishing marginal utility,¹⁵¹ it can also be argued that this marginal utility is likely to be diminishing as the amount of accounting information increases. In theory, this means that a firm where there is no pre-existing accounting information system is likely to derive more benefit from the record keeping system imposed by tax compliance than a firm where one is already in place. However, in practice the very existence of managerial benefits and their magnitude may also depend on how accounting information is valued by the firm owner. In the extreme, if the owner-manager does not see any value in using the information derived from the record keeping system, either because the information is irrelevant to decision-making or because it is *perceived* to be irrelevant, then the subjective value of the managerial benefits will be zero.

It may also be argued that managerial benefits have an objective value, regardless of the manager's appreciation of that value. Managerial benefits can be conceived as being represented by the economic gains obtained through the increased business performance, which is brought about by improved decision-making. Yet, it can be further argued that the realisation of these gains is in fact dependent on how effectively, accounting information is used by the owner-manager. Where the owner-manager does not perceive the potential benefit to be derived from using accounting information, that information will be ignored and the managerial benefit corresponding to increased business performance will not materialise. Moreover, even where better performance is achieved the resulting gains may not be attributable to usage of accounting information.

Empirical evidence suggests that at least a segment of the business taxpayer population recognised some value in using the financial information generated by the record keeping system. However, there is also some indication that SME owner-managers generally valued financial information less than large firms.¹⁵² Only 37.5 per cent of small business taxpayers used financial statements for internal management, against 82.8 per cent of large businesses.¹⁵³ Some authors have pointed out that one of the main reason why SME taxpayers do not perceive managerial benefits, is that they may be too busy with tax compliance to monitor their cash flow and scrutinize their financial situation.¹⁵⁴

The apparent inconsistency between the existence of managerial benefits in theory, and the reality of their perception by business taxpayers is at the core of the problem posed by the valuation of this type of compliance benefit. Theoretically, an objective value of managerial

¹⁴⁹ Sandford et al, above n 6, 91.

¹⁵⁰ R Lipsey and K Chrystal, *An introduction to positive economics* (8th ed, 1995).

¹⁵¹ This basic assumption, sometimes called the law of diminishing marginal utility asserts that '[t]he utility that any consumer derives from successive units of a particular product diminishes as total consumption of the product increases while the consumption of all other products remains constant': *ibid*.

¹⁵² Evans et al, *A Report into the Incremental Costs of Taxpayer Compliance*, above n 4.

¹⁵³ *Ibid* 116.

¹⁵⁴ C Evans and Michael Walpole, 'The hidden costs of a GST: An international perspective' (1998) 12(4) *Policy* 3.

benefits could be based either on the valuation of the benefits actually obtained by the business or on the costs of the resources which would produce the same benefits.

The measurement of managerial benefits using the basis of 'actual' benefits derived would require the valuation of the economic gains derived from improved business performance. This method presents a number of conceptual and practical problems. Firstly, measuring managerial benefits on the basis of economic gains relies on the premise that the use of accounting information *necessarily* provides an advantage to the firm. At this stage, the relationship between comprehensiveness of accounting information and improved business performance has not been convincingly established.¹⁵⁵ Secondly, valuing the pay-off resulting from the improved accounting information is in itself problematic because it would be difficult to identify and measure the incidence of that particular factor on business performance.¹⁵⁶

Following a valuation approach based on the cost of resources, the value of managerial benefits would be assumed to be equivalent to the cost of obtaining the same information either by acquiring an internal information system, or by seeking the information from an external party. The advantage of this method is that it is consistent with economic utility theory which posits that utility is measured by the largest amount that consumers would be prepared to pay to acquire the good from which they derive utility.¹⁵⁷ However, there are several practical difficulties associated with the cost of resources approach. First, while the cost of obtaining the information from an external party may be readily available, the computation of the cost of generating the information internally may be more problematic, particularly because of the accounting/tax cost overlap mentioned earlier. Second, this method assumes that all business managers will derive the same managerial benefits from particular types of accounting information.

As discussed previously, the magnitude of the benefit derived by the owner-manager as result of using financial information will ultimately depend on the effectiveness of usage of that information for decision-making. The degree of effectiveness will itself be influenced by three main factors: the quality of the information generated by the information system, the degree of appreciation that each manager-owner has of that information and the nature of the decisions that the information will be used for.

A subjective evaluation of managerial benefits is likely to be influenced by the personal characteristics of the information user, alongside other factors such as the type, age, size and profitability of the business.¹⁵⁸ Among the personal characteristics, accounting training was identified by Sandford as a possible determinant of perceived managerial benefits. Overall, individuals who had no accounting training were more likely to perceive benefits than those who had received formal training as bookkeepers or accountants.¹⁵⁹ Other possible factors determining perception and usage of accounting information include the status of the person preparing tax compliance information (business owner, manager or employee), educational background and motivation.¹⁶⁰

¹⁵⁵ Richard McMahon, 'Business growth and performance and the financial reporting practices of Australian manufacturing SMEs' (2001) 39(2) *Journal of Small Business Management* 152.

¹⁵⁶ Richard Due, 'The valuation of information' (1996) 13(1) *Information Systems Management* 68.

¹⁵⁷ Lipsey and Chrystal, above n 150, 129.

¹⁵⁸ In most small businesses, the user of accounting information will be the owner-manager himself or his close family. On this issue see: J Ang, 'On the theory of finance for privately held firms' (1992) 1(3) *The Journal of Small Business Finance* 185; D J Storey, *Understanding the small business sector* (1994); J A Welsh and J F White, 'A small business is not a little big business' (1981) 59(4) *Harvard Business Review* 18.

¹⁵⁹ Sandford et al, above n 6, 95.

¹⁶⁰ Nadine Lybaert, 'The information use in a SME: Its importance and some elements of influence' (1998) 10(2) *Small Business Economics* 171.

While there are limitations to both objective and subjective methods of measuring managerial benefits, it is contended that a combination of the two approaches would offer the best opportunity to resolve the measurement dilemma. Firstly, the concurrent use of two approaches would allow the researcher to offset the weaknesses of one approach with the strengths of the other. Secondly, it will offer the possibility of triangulation, thereby increasing the validity of the findings. Thirdly, the analysis of discrepancies between the results obtained from the objective valuation method and the subjective valuations by business owners will improve our understanding of why some managerial benefits may be realised and not perceived, and others may be perceived and not realised.

VI IDENTIFYING THE RESEARCH GAP ON MANAGERIAL BENEFITS

In light of the above discussion, it appears managerial benefits are an under-researched topic. There is an urgent need for more empirical evidence, more analysis and more theoretical research on this issue. First, there is a need for fresh and comprehensive data on managerial benefits. Only two studies so far have collected detailed data on managerial benefits and attempted to estimate them. Both studies were carried out in the UK in the 1980s and 1990s and both restricted their analysis to VAT. We need more across-the-board evidence about managerial benefits arising from compliance with all taxes including income tax and company tax. Second, more than two decades after Sandford first identified managerial benefits of compliance with VAT, we still do not know how widely these benefits are spread among business taxpayers and whether specific factors determine the level of perceived benefits. Qualitative information collected in New Zealand and in Australia has confirmed that business taxpayers, particularly small business taxpayers, could identify some managerial benefits derived as a result of tax compliance activities. However, there are inconsistencies between findings from different surveys and anecdotal evidence obtained from case studies needs to be confirmed by large scale systematic studies. Further research is also necessary in order to shed light on a number of issues. What is the influence of tax compliance on the acquisition of computerised information systems by small business taxpayers? What are specific benefits derived from using these systems which are perceived by owner-managers? Is the additional information produced by these systems used in a manner that will be beneficial to the organisation? Are there specific factors that affect the way managerial benefits are perceived and actually derived? Third, it has been argued earlier that the valuation of managerial benefits is linked to the resolution of the 'joint costs' problem mentioned by Allers and others. Although a number of papers have discussed the problem of joint costs in theory and have proposed general approaches, there has been no attempt so far to deal with this problem in practical terms. It is suggested that a comparison between businesses who have to comply with the normal requirements of the tax system with similar businesses exposed to minimal tax obligations would allow researchers to quarantine tax-related costs from costs related to core accounting and business functions.

It is essential that all above issues be addressed before the problem of the measurement of managerial benefits can be resolved. Sandford recognised that subjective valuations by taxpayers did not provide a reliable measure of managerial benefits and that further research was required in this area.¹⁶¹ It is expected that a better understanding of the conditions in which managerial benefits arise and an analysis of the factors that leads to their perception will allow researchers to develop a sound methodology for their valuation.

¹⁶¹ Sandford et al, above n 6, 95.

AN OLD METHODOLOGY IN A NEW WORLD: A COMMENT ON OUR CURRENT SYSTEM OF JUDICIAL DECISION MAKING IN TAX CASES

JUSTIN DABNER*

The traditional approach to resolving tax disputes adopted by the judiciary is to look to the words of the legislation to identify parliament's intention. However this approach is founded on the fallacy that words have a 'correct' meaning which is there for the judiciary to discover. In fact, language is inherently imprecise and, typically, in difficult tax cases the determination of how the legislation was meant to apply to the facts of the particular case is at best a guess. Yet, as if in fear of a great lie being discovered, the judiciary will seek to clothe their guess with respectability by employing rhetorical devices designed to persuade the reader that they have identified the undeniable truth. However, ultimately, such a subterfuge does not do justice to the parties to the litigation nor establish an effective precedent. These cases fail a cost-benefit analysis. They indicate that a new approach is needed that is prepared to acknowledge the inherent uncertainty of language and to seek to establish a precedent by reference to the underlying policy objectives of the legislation. This will require mechanisms to assist the courts to identify the relevant policy considerations and to ensure that justice is done in the case at hand.

I INTRODUCTION

A definition of insanity is doing the same thing but expecting a different result.

Such is an apt description of our belief that the uncertainty in the tax law can be resolved through the traditional system of litigation and judicial rulings. The taxation community keenly awaits the next High Court decision that will resolve a difficult area of tax law, but it never comes. Each High Court decision is met with disappointment, critical disclaim and the identification of further grey areas and difficulties. Yet we sprout the creed that we require a further High Court decision to clarify the issues.

Why is this so? Burton has presented a cogent, albeit controversial, explanation.¹ He explained that the idea that judicial decisions are 'correct' is a fallacy. This arises from the misplaced belief that in tax law disputes there is one undeniable truth that the judiciary is charged with finding and thought to be capable of identifying. Rather, he suggested that judges are, after all, only human and their views on tax issues are only as 'correct' as those of anyone else, or at least those of anyone with considerable intellect and tax learning. Thus judicial decisions are simply justifications of one person's view. However, with a view to convincing us that their decisions are 'correct,' judges adopt certain rhetorical devices. For example, they might refer to common sense, various rules of interpretation, past precedent and fairness.

* PhD (Tas), B Comm LLB (Hons) (Tas); Associate Professor, Law School, James Cook University.

¹ Mark Burton, 'The Rhetoric of Tax Interpretation: Where Talking the Talk Is Not Walking the Walk' (Paper presented at the Australasian Tax Teachers' Association Conference, Wellington, 26-28 January 2005). Sir Neil MacCormick has previously expressed similar views but now sees the circumstances in which judges make the law, as distinct from deducing it from interpretational practice, as less common: see Neil MacCormick, *Rhetoric and the Rule of Law* (2005).

So the ‘correct’ judicial decision is really the one that sounds the most convincing in the sense of appealing to rhetorical devices. At least this is the case for lower court judges who must be able to convince appeal judges. Of course, ultimately the ‘correct’ decision will be that of the majority at the highest level to which the case is appealed, although even their decisions are subject to the caveat that if they are not sufficiently convincing they may be subsequently rejected or, more deferentially, distinguished by a court of equal standing.

Burton’s thesis rests on the notion that there is no single correct view of the underlying tax legislation which the judiciary is considering. This is because legislation is a product of words and language is an imperfect and imprecise mechanism for describing intention. If Burton’s thesis is an accurate description of what judges really do and how tax disputes are resolved, then what are the implications? The author has previously argued that faced with this new reality we need to change the way in which we resolve and settle tax disputes to recognise the fallacy of the belief that the answer can always be found in the words of Parliament.² I have attempted to illustrate, by reference to cases dealing with the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* (‘ITAA36’), that the traditional approach adopted by the judiciary simply creates another level of complexity and uncertainty. Furthermore, the methodology employed tends toward futile attempts to divine the ‘correct’ meaning of legislation thereby failing to address what would be a much more worthy consideration, namely, what is best for the economic and social well-being of the country.

My argument is that the traditional approach to attempting to find the answer from the words used by Parliament results in a technical analysis of semantics and minutiae. Burton would add that in an effort to make each decision sound correct the judiciary utilise a plethora of often competing rhetorical devices that result in inconsistency.

I suggest that the current approach needs to be abandoned and there should be recognition of the fact that legislation is inherently uncertain and that the cost of this uncertainty needs to be appropriately shared by the community. To this end I have identified eight strategies that should be adopted.

- 1 ***Legislative purposive rule.*** As a starting point, there should be an express mandate in the tax legislation requiring the courts to interpret the legislation to give effect to its underlying purpose and to read words into a provision if necessary to further its purpose. Whilst the purposive approach is not without its limitations, this might restrict the use of competing rhetorical devices by the judiciary and see most cases resolved in a way that Parliament would presumably have considered to be in the best interests of the country.³
- 2 ***Purposive legislation and objects clauses.*** To assist the judiciary to ascertain the purpose of legislation, a drafting methodology that abandons detailed legislation in favour of statements of broader principle and the use of objects clauses should be adopted. However, it is acknowledged that due to the inherent uncertainty of language the debate over how best to draft tax legislation is of secondary significance. At least less detailed legislation is less likely to obscure the underlying purpose.

² Justin Dabner, ‘There Are Too Many Witchdoctors in Our Tax Courts: Is There a Better Way?’ (Paper presented at the Australasian Tax Teachers’ Association Conference, Wellington, 26-28 January 2005).

³ But see below n 36 and n 38 on the competing theories behind the legislative process.

- 3 ***Unfettered reference to extrinsic material.*** Abandoning the rule that Parliament's purpose is to be found solely in the words of a provision would permit the judiciary to refer to whatever extrinsic material is considered useful and give it the appropriate weight.
- 4 ***Substance over form.*** Substance should dominate as the inquiry before the courts must be as to the manner in which Parliament intended a given economic result to be managed.
- 5 ***Indeterminable purpose — Adopt the best policy solution.*** Where the purpose(s) of the legislation is obscure or it does not assist in resolving the issue at hand, the judiciary should undertake a policy analysis and openly decide the matter by reference to the preferred policy outcome.
- 6 ***Expanded discretion in quantifying liability.*** Given the imperfections of language, innocent taxpayers may have been positively misled by the legislation, especially where a court has adopted a broad purposive approach or policy analysis. Therefore, the judiciary should be provided with an expanded discretion to quantify liability by taking into account the clarity by which tax policy has been expressed and the taxpayer's conduct. This could extend from simply refraining from entering a costs order through to negative penalties or discounts off the tax liability. Furthermore, a fund should be established to compensate taxpayers who have incurred expense arising from their interpretation of what has been held by a court or the tax policy committee (see point seven below) to be misleading legislation but whose cases did not proceed to litigation. In this way the inherent costs arising from the imprecision of language could be borne by the community generally rather than by individual taxpayers.
- 7 ***Tax policy committee.*** A tax policy committee should be established with representatives from relevant stakeholders such as the Australian Taxation Office ('ATO'), the Treasury, the Australian Council of Social Service, business and the profession. The Committee's primary role would be to enunciate the perceived policy behind tax legislation, or a desirable policy direction where the existing policy is unclear, and to monitor whether tax rulings reflect this policy. Applications could be made to the Committee by a taxpayer (following an adverse decision on a ruling application by the ATO). The deliberations of the Committee would not be binding on courts but would provide highly persuasive evidence of either the existing or desirable policy position and, therefore, would be unlikely to be contested.⁴
- 8 ***A 'norm campaign' to change community values.*** There is evidence to suggest that taxpayer perceptions of unfairness, excessive taxation and regulation are determinants that contribute to avoidance of their obligations under the tax system.⁵ In order to improve the

⁴ The ATO GAAR Panel is heading in this direction: ATO, *Law Administration Practice Statement PS LA 2005/24* (2005). This has been discussed in a paper by the (former) Federal Commissioner of Taxation: Michael Carmody 'Corporate Governance and Its Role in Tax' (Paper presented at the Taxation Institute National Convention 'Tax Unmasked', Perth, 17 March 2005).

⁵ See Valerie Braithwaite, 'Perceptions of Who's Not Paying Their Fair Share' (Working Paper No 54, Centre for Tax System Integrity, Australian National University, Canberra, 2004); G Richardson, 'An Exploratory Cross-cultural Study of Tax Fairness Perceptions and Tax Compliance Behaviour in Australia and Hong Kong' (2005) 31 *International Tax Journal* 11 and M Richardson and A J Sawyer, 'A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects' (2001) 16 *Australian Tax Forum* 137, 148, 177-84. As recent research indicates, the relationship between personal ethics and perceived social norms on the one hand and tax compliance on the other is complicated: M Wenzel, *Motivation or Rationalization? Casual Relations between Ethics, Norms and Tax Compliance* (2005) Centre for Tax System Integrity, Australian National University <<http://ctsi.anu.edu.au/publications/taxpubs/Wenzel.JEP2.pdf>> at 6 June 2006.

public perception of the tax system a campaign should be instituted to persuade taxpayers that they have both a legal and moral obligation to pay tax in pursuit of the Government's (now more transparent) socio-economic objectives. This campaign would emphasise the moral obligation to contribute to the cost of public resources as well as the legal sanctions for failing to comply. It might also encourage whistle-blowing and seek to render those who are non-compliant, especially non-compliant corporations, public pariahs. In contrast, in support of good citizenship the campaign might (with their consent) publicise the names of the highest tax paying corporations and individuals. One consequence of this campaign might be added pressure on tax advisers to bring a broader, even moral, dimension to the provision of their tax advice.⁶

Ultimately, I suggest that we are in denial if we believe that the current system of tax dispute resolution can ever deliver more clarity and certainty. Our reluctance to change is costing us dearly. The community is not receiving good value for its expenditure on the judiciary and tax court structure. This article further discusses the inadequacies of the current judicial tax dispute resolution system and elaborates on the proposed reforms above. It will be demonstrated that the reforms are not as radical, as they may appear as there is already some precedent in mandates expressed in other areas of economic law for a more policy orientated approach by the judiciary.

II THE TRADITIONAL APPROACH TO JUDICIAL DECISIONMAKING IN TAX CASES FAILS CONTEMPORARY NEEDS

The universal approach of common law tax judges is to seek to resolve a case by identifying the 'true' or 'correct' meaning of the legislation: that is, to identify the intention of Parliament from the words used in the statute.⁷

My thesis is that typically tax disputes arise because it is simply impossible to determine what Parliament intended from its words. We often observe Parliament respond to a judicial decision it does not like by enacting further legislation, that is, more words. But typically this simply generates new issues for resolution and again the judiciary becomes involved. The result is that we see the growth of legislation spiralling out of control and judicial decisions generating more uncertainty and complexity. The administration of, and compliance with, the system becomes a massive burden. Ultimately the public loses confidence in it and there are continual demands for reform.

A *An Illustration: FCT v Hart*⁸

A perfect illustration of this is the High Court's most recent pronouncement on the general anti-avoidance provisions of Part IVA of the *ITAA36* in *Hart*. In his speech at the launch of the

⁶ McBarnett suggests that tackling tax avoidance through general principle drafting, a substance over form approach and purposive interpretation by the judiciary and the implementation of a GAAR will just lead to creative compliance, which is a problem not a solution. She argues the need to change the attitudes of taxpayers and taxpayer advisers toward taxation so that it is seen as a positive contribution, not a negative imposition: D McBarnett, 'When Compliance Is Not the Solution but the Problem: From Changes in Law to Changes in Attitude' in Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Tax Evasion* (2003).

⁷ See, for example, Gary Heilbronn et al, *Introducing the Law* (5th ed, 1996) at 137 and following.

⁸ (2004) 217 CLR 216 ('*Hart*').

publication *Global Challenges in Tax Administration*,⁹ Sir Anthony Mason referred to the adherence of Australian courts to a narrow conception of judicial power and the failure to creatively interpret statutes. It is not surprising to the author that he thereafter made specific reference to the decision in *Hart* as not having done much to lessen the conflicts and tensions that exist within the tax laws. The facts were that the taxpayers took out a wealth optimiser split loan product to enable them to purchase a home and retain their former residence as an investment property. The product was structured such that in the early years of the loan all repayments were directed towards paying off the home loan while allowing the interest on the investment property loan to be capitalised. Interest was then imposed on the capitalised portion. In essence, the progressive shift of the loan balance from the residential side of the account to the investment side permitted interest on the loan funds used to purchase the Harts' home to be claimed as a tax deduction.

The High Court held, overruling a unanimous Full Federal Court, that the tax benefit associated with the loan was subject to Part IVA. According to the transcript, a key reason for leave to appeal to the High Court being granted was to clarify the operation of the definition of 'scheme' for the purposes of Part IVA.¹⁰ In fact, the decision has done anything but provide clarity. The pivotal decision of Callinan J is open to competing interpretations. One interpretation would see the Commissioner's powers under Part IVA expanded, while the alternative interpretation would merely reinforce the status quo that has prevailed since the first High Court decision on Part IVA in *FCT v Peabody*.¹¹

The uncertainty which the High Court decision created is illustrated by Hill J's subsequent attempt to make sense of it in *Macquarie Finance Ltd v FCT*¹². His Honour clearly had great difficulty identifying a precedent on the meaning of 'scheme' from the High Court decision. Fortunately for his Honour, the facts permitted him to avoid having to reach a decided view on the scope of the scheme. Ultimately, whilst concluding with reluctance that Part IVA (as interpreted in *Hart*) applied, his Honour expressed doubt as to whether this would have been Parliament's intention when Part IVA was enacted.¹³

⁹ Sir Anthony Mason, 'Global Challenges in Tax Administration Launch' (Speech delivered at the *Global Challenges in Tax Administration* Launch, Sydney, 18 August 2005).

¹⁰ See the transcript of the special leave application: *Commissioner of Taxation v Hart* S279/2002 11 April 2003 (especially the submissions of Shaw QC for the Commissioner at page 4).

¹¹ (1994) 181 CLR 359. For a discussion of the possible interpretation of the decision in *Hart* see Mark Burton and Justin Dabner, 'Hart — The Death of Tax Planning?' *CCH Tax Week* Issue 24, 24 June 2004; P Donovan, 'The Aftermath of Hart's Case — A Case for Reform of Part IVA?' (2004) 39 *Taxation in Australia* 253; Dominic Carbone and John Tretola, 'Does Hart's Case Change the Application of Part IVA?' (Paper presented at the Australasian Tax Teachers' Association Conference, Wellington, 26-28 January 2005); Michael D'Ascenzo, 'Part IVA: Post Hart' (2004) 7 *Journal of Australian Taxation* 357.

¹² [2004] FCA 1170.

¹³ On appeal a majority of the Full Federal Court disagreed with Hill J on the application of Part IVA to the facts whilst expressly endorsing his Honour's summary of the relevant law: *Macquarie Finance Ltd v Commissioner of Taxation* [2005] FCAFC 205. Hill J elaborated on his view as to how *Hart* may have significantly expanded the application of Part IVA in 'The Incremental Expansion of Part IVA' (2005) 40 *Taxation in Australia* 23. See also Justin Dabner, 'So Just What Did Hart Decide: *Macquarie Finance*' *CCH Tax Week*, Issue 45, 18 November 2004; M Cashmere, 'Part IVA after Hart' (2004) 33 *Australian Tax Review* 131; P Donovan, 'The Aftermath of Hart's Case — A Case for Reform of Part IVA?' (2004) 39 *Taxation in Australia* 253. It must be acknowledged that the ATO does not share the view of his Honour and most other commentators that the decision does not clarify but confuse: Michael D'Ascenzo, 'Part IVA: Post Hart' (2004) 7 *Journal of Australian Taxation* 357. However, a comparison of the conclusions in that article with conclusions drawn by others would not support the ATO's position. For example, on the critical issue whether the case rejects the view that a scheme needs to stand on its

The decisions at all levels in the *Hart* litigation were classic tax judgments in the sense that the focus of the judges was to identify the true application of Part IVA through consideration of its language. Thus the decisions degenerated into a debate over semantics and minutiae, the main focus of which was the definition of the word ‘scheme’. On one argument, if the ATO could select a narrow scheme of, say, the borrowing on its own, then it might be easier to conclude that the dominant purpose of the scheme was to secure a tax benefit. On the other hand, a requirement to identify within the scheme commercial motivations for the borrowing might lead to a different conclusion. Thus argument centred on what scheme the Commissioner could select and whether the facts selected had to ‘stand on their own feet’ and not be ‘robbed of all practical meaning’.¹⁴

Alternatively, it may not matter now exactly what the test is for determining the relevant scheme, as the scheme (whatever it is) must be viewed in the context of the surrounding circumstances in any event.¹⁵ Of course, this begs the question as to what are the relevant surrounding circumstances and how they are weighted. The relaxation of the ‘scheme’ requirement places even greater importance on the application of s 177D of the *ITAA36* (factors to consider in identifying the dominant purpose) in striking an appropriate application of the Part. Arguably the approach adopted by the courts to date in distilling a dominant purpose from these factors has essentially been a ‘smell test’ rather than a scientific approach. The approach generally has been to make a conclusion ‘on balance’ from a consideration of these factors.¹⁶ Although the Commissioner has, following his success in *Hart*, undertaken to apply Part IVA in a ‘practical’ way¹⁷ it is possible that the next High Court case concerning Part IVA will have to consider this very issue.

In support of the positions taken by the judges in *Hart*, we can see that the judges rely on many tried and tested rhetorical devices.¹⁸ Thus, Gummow and Hayne JJ suggest that a test they disavow is ‘far from clear’ and where it was used before it was ‘used in a very different context’.¹⁹ In any event there is no basis for the introduction of a ‘judicial gloss’ into the *ITAA36*.²⁰ Furthermore, at one stage Callinan J employs a literal interpretation in his judgment.²¹ Nowhere in any of the judgments is there any attempt to examine the issue under consideration from a policy perspective.

own feet, contrast the views of D’Ascenzo with those expressed in the otherwise supportive analysis of the case by Dominic Carbone and John Tretola, ‘Does *Hart*’s Case Change the Application of Part IVA?’ (Paper presented at the Australasian Tax Teachers’ Conference, Wellington 26-28 January 2005), 15-18. Thus, even those rare supporters of the case are unable to agree on what it decided.

¹⁴ See, eg, (2004) 217 CLR 216, 235–241, Gummow and Hayne JJ.

¹⁵ See the discussion by Hill J in *Macquarie Finance Ltd v FCT* [2004] FCA 1170, (especially from paragraph 110) and the judgment of Gummow and Hayne JJ in *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216, 241–5.

¹⁶ *FCT v Sleight* 2004 ATC 4477, 4492, Hill J.

¹⁷ Michael Carmody, ‘Corporate Governance and Its Role in Tax’ (Paper presented at the Taxation Institute National Convention ‘Tax Unmasked’, Perth, 17 March 2005).

¹⁸ Referred to by Mark Burton, ‘The Rhetoric of Tax Interpretation: Where Talking the Talk Is Not Walking the Walk’ (Paper presented at the Australasian Tax Teachers’ Association Conference, Wellington, 26-28 January 2005).

¹⁹ (2004) 217 CLR 216, 237 - 238.

²⁰ *Ibid*.

²¹ *Ibid* 259-60.

B A Cost Benefit Analysis of Hart

In this section, I seek to analyse whether the community received good value for the resources allocated to *Hart's* case. First, was justice achieved between the parties, namely the taxpayers and the ATO? It must be appreciated that the amount of deductions at issue in the case was only around \$800.²² The Harts subsequently made public comment to the effect that they did not have tax considerations predominately in mind when they took out the loan.²³ That is, there was no evidence of serious malfeasance and the tax revenue in question was minimal.

Secondly, did *Hart* create a valuable precedent to aid the future interpretation of the tax laws? It is notable that no cost orders were sought by the ATO which saw the case as a test case.²⁴ Certainly the taxation of split loan products was resolved in favour of the ATO. However, the basis of the special leave application being upheld was that the High Court wished to establish a precedent clarifying Part IVA. The preponderance of both academic and judicial analysis to date considers that it is difficult to determine what the case stands for; on one view, it may be a considerable departure from previous learning and possibly Parliament's intention when the legislation was enacted.²⁵

These could be considered to be marginal returns to the community in terms of revenue, justice, or the establishment of clear precedent. Given this, it is appropriate to reflect on how much the decision cost and whether these funds could have been more effectively employed elsewhere. It is very difficult to calculate the cost of the case without access to the financial records of the various parties involved. The table on the following page is a legal academic's attempt to approximate what the cost might have been, subject to some very coarse assumptions. This rough estimate is sufficient for current purposes to support the proposition that the attempt to resolve through the court system as to how Part IVA is meant to apply is a very costly process. The resolution of its application to one type of transaction, namely the split loan product, has cost the parties involved around \$1.2 million and we remain no wiser as to its application generally.

The opportunity to create the split loan product under consideration in *Hart* only came about because of uncertainty as to how the tax laws apply, especially the application of Part IVA. Therefore, the Table on the following pages includes the costs of generating the product and a proxy for the costs of its subsequent marketing, sale and implementation.²⁶ Added to these expenses are the ATO's costs in reaching a position on the product and the costs of the subsequent dispute with the taxpayer. The Table attempts to identify the cost for each group of relevant stakeholders, namely the financial community (including the taxpayer), the ATO and the public court system.

²² See F Buffini, 'Loan Was Not a Rort', *The Australian Financial Review* (Sydney), 28 May 2004 at 4.

²³ Ibid.

²⁴ It is widely believed that the ATO's focus in litigating the case to the High Court was to obtain a precedent that might override the Full Federal Court decision in *Eastern Nitrogen v FCT* 2001 ATC 4164 which had upheld the tax effectiveness of sale and lease back financing arrangements. The High Court had refused leave to appeal on the Part IVA point in *Eastern Nitrogen* on the basis that there was no error of law at issue, *Commissioner of Taxation v Eastern Nitrogen Ltd* B28/2001 (15 February 2002). The ATO was concerned that this had been interpreted as an endorsement of the approach and decision of the Full Federal Court in that case.

²⁵ In particular see Hill J in *Macquarie Finance Limited v FCT* [2004] FCA 1170 at paragraph 120.

²⁶ This takes into account expenses such as printing of brochures, advertising generally, training sales staff, establishing relevant accounts and maintaining records.

There are likely to have been many more indirect costs which would be difficult to quantify (and unnecessary for the purposes of this rough approximation). For example, there would have been many other taxpayers who purchased the split loan or a similar product (maybe after obtaining advice) and who may have either been the subject of a dispute with the ATO or who subsequently voluntarily amended their relevant assessments. Both taxpayers and the ATO would have incurred financial, accounting and legal expenses and possibly interest and penalties. There would have been considerable professional (and, indeed, academic) time devoted to understanding the product and its tax implications at the various stages of its life; from generation, to ATO ruling, to the various court decisions. These costs can all be related back to the product's initial creation, conceived from the uncertainty in the way our tax laws have been and are interpreted.

Set out here are some assumptions used in preparing the Table.

- 1 The relevant hourly rates adopted are those reflecting the likely cost to the relevant stakeholder. So, for example, in the case of public court costs the rate for the judiciary is their likely employment cost rather than any charge out rate based on opportunity costs.
- 2 The financial communities' internal hourly rate is assumed to be an average of \$100 per hour, with legal and tax advisers and junior counsel at \$400 per hour and senior counsel at \$600 per hour.
- 3 The ATO's internal hourly rate is also assumed at \$100 per hour with their legal and advisers at \$400 per hour and counsel at \$600 per hour.
- 4 The hourly employment rate for the judiciary is assumed at \$200 per hour.
- 5 Fixed and variable court costs include court staff such as security, judges' associates, transcribers, bailiffs and the cost of the infrastructure. This is assumed at \$1000 per hour. Given the inclusion of these amounts application and appeal fees payable by the parties have not been included.
- 6 The decisions record that the hearing took two days, the Full Federal Court appeal one day and it is assumed that the High Court appeal took a further day. Given preparation time, ten hour days are assumed.

It is argued that even if the assumptions used in preparing the Table are inaccurate in many respects, the Table nevertheless illustrates that the legal process by which the application of Part IVA to split loan products was resolved is likely to have been very costly. As with the interest at issue, the cost of uncertainty in the application of Part IVA continues to compound — even after resolution of the case itself and the closing down of the split loan scheme. The cost of the High Court's failure to provide a clear precedent on the application of Part IVA *generally* continues to resonate as hours of professional, academic and judicial time are spent on attempting to distil some sense from the case and identify its implications. Some might argue that this uncertainty helps to discourage tax avoiders. However it might also discourage economically desirable activity as even the Commissioner acknowledges that businesses thrive on certainty.²⁷ Economic impact statements now typically accompany tax reform proposals and tax bills. It may be a worthwhile exercise for such statements to be drawn up in relation to tax cases so that we, as a community, can start to focus on their true costs and benefits.

²⁷ Michael Carmody, 'Corporate Governance and Its Role in Tax' (Paper presented at the Taxation Institute National Convention 'Tax Unmasked', Perth, 17 March 2005).

Table: What did the decision in *Hart* cost?

Activity	Time (hours)			Cost (\$)			Total
	Taxpayer/ Financial Sector	ATO	Courts	Taxpayer/ Financial Sector	ATO	Courts	
Product Development (In-house/External Advisers)	500/ 200			50,000 80,000			130,000
Marketing, Sale & Implementation	3,000			300,000			300,000
Ruling by ATO		500			5,000		5,000
First Objections & Advice	10			4,000			4,000
Amended Assessment		50			5,000		5,000
Second Objections & Advice	10			4,000			4,000
Reconsideration by ATO		50			5,000		5,000
Referral to Federal Court	10			4,000			4,000
Pre-trial Activities	10	10		4,000	4,000		8,000
Preparation for Trial	25	25		10,000	10,000		20,000
Solicitors at First Instance	20	20		8,000	8,000		16,000
Counsel at First Instance	1 SC x 20 2 JC x 20	1 QC x 20 1 JC x 20		12,000 16,000	12,000 8,000		48,000
Judge at First Instance			20			4,000	4,000
Fixed/Variable Court Costs			20			20,000	20,000
Writing Judgment			100			20,000	20,000
Review by ATO and Taxpayer	10	10		4,000	4,000		8,000
Full Federal Court Appeal Application	10			4,000			4,000
Review by ATO		10			4,000		4,000
Preparation for Full Federal Court	25	25	30	10,000	10,000	6,000	26,000
Solicitors on Full Federal Court Appeal	10	10		4,000	4,000		8,000

Activity	Time (hours)			Cost (\$)			
	Taxpayer / Financial Sector	ATO	Courts	Taxpayer/ Financial Sector	ATO	Courts	Total
Counsel on Full Federal Court Appeal	1 SC x 10	1 QC x 10 1 JC x 10		6,000	6,000 4,000		16,000
Three Judges on Full Federal Court Appeal			30			6,000	6,000
Fixed/Variable Court Costs			10				10,000
Writing Judgments (One principal judgment at 100 hours and two additional judgments at 25 hours)			150			300,0 00	300,000
Review by ATO and Taxpayer	10	10		4,000	4,000		8,000
Leave Application		10			4,000		4,000
Review and Preparation Solicitors on	10 1	10 1		4,000 400	4,000 400		8,000 800
Application (Assume 1 hour)							
Counsel on Application (Assume 1 hour)	1 SC x 1 1 JC x 1	1 QC x 1 1 JC x 1		600 400	600 400		2,000
Judges on Application (2 x 30 minutes)			1			200	200
Fixed/Variable Court Costs			1				1,000
Preparation for High Court	25	25	50	10,000	10,000	10,00 0	30,000
Solicitors on High Court Appeal	10	10		4,000	4,000		8,000
Counsel on High Court Appeal	1 SC x 10 1 JC x 10	2 QC x 10 1 JC x 10		6,000 4,000	12,000 4,000		26,000
Five Judges on Appeal Fixed/Variable Court Costs			50 10				10,000 10,000
Writing Judgments (3 at 100 hours each)			300				60,000
Implementation of Decision		10			1,000		1,000
Analysis of Implications for Split Loan Products	100	100		10,000	10,000		20,000
					Total		1,164,000

My proposition is that there must be a way to generate a better return for the community from the investment in tax cases. Cases that focus on semantics and minutiae will inevitably be a futile investment. Unfortunately, with occasional exceptions, the judicial mindset is to focus on the words rather than any bigger picture. It is as if the words present a comfort zone which permit wider issues, such as economic well-being and social equity, to be avoided.

Perhaps it is unfair to solely blame the judiciary, as the tax advisory profession is all too ready to hide behind literal interpretations of the law in order to avoid considerations of what might be socially acceptable and ethical behaviour. Legal academics continue to teach the study of law in a traditional way with only limited reference to normative issues.²⁸

III THE ALTERNATIVE IS NOT SO RADICAL

The alternative approach I have proposed is really not so radical. It acknowledges that there will be cases where it is impossible to ascertain how Parliament intended the transaction to be taxed and any attempt to determine Parliament's intention from the words would be mere speculation. Furthermore, any attempt to justify the decision reached would be merely an exercise in rhetoric that might be readily rejected in subsequent cases. The result is a determination lacking precedential value and generating further uncertainty.

A A Better Approach

The better approach in such cases would be to concede that Parliament's intention is unclear and to apply an overriding principle to the decision, namely, what is best for the country. The judiciary would then state the law by reference to the underlying principles of our taxation system which might be articulated as first, raising revenue for the government; second, achieving social equity; and third, advancing the country's economic well-being.

The opposing parties to a case could then lead evidence and address arguments to support their preferred interpretation of the law with reference to these principles. Ultimately the judiciary would be required to make a value-laden decision but it would be made with express reference to the values that the judges are advancing. Should these be inconsistent with the preferred policies of the government, then the government would be in a position to pass amending legislation with the benefit of a record of expert testimony and the insight of the judiciary on the relevant policy considerations.

Some might argue that such an approach encourages judicial activism and erodes parliamentary sovereignty. It must be appreciated that by virtue of its ability to enact amending legislation Parliament has the ultimate power, at least prospectively. There are already illustrations of such quasi-legislative authority being invested in administrators and, therefore, ultimately quasi-judicial and judicial bodies by provisions contained in other economic legislation. For example, ss 665A, 669, 673, 741 and 1075A of the *Corporations Act 2001* (Cth) permit the Australian Securities Investment Commission ('ASIC') and, ultimately, the courts to override express legislation to give a better effect to the policy behind takeovers and fundraising provisions.²⁹ In

²⁸ Grbich takes the view that tax academics need to be more critical of tax judgments and tax lawyers need to be better tooled: Yuri Grbich, 'New modalities in tax decision-making: applying European experience to Australia' (2004) 2 *eJournal of Tax Research* 125.

²⁹ See also Part VII of the *Trade Practices Act 1974* (Cth), especially s 88, which empowers the Australian Competition and Consumer Commission to authorise arrangements that would otherwise be anti-competitive and in breach of the Act. In exercising this power, the Commission is to weigh up how the public interest is best served.

the context of the voluntary administration provisions, s 447A of the *Corporations Act* empowers the courts to make orders about how the provisions are to apply to a particular company with the only limit being the aim to further the objects of the provisions. By virtue of these provisions, ASIC and the courts are given a very broad discretion and a mandate to ensure that the rights of parties affected by their decisions in such cases are protected. Furthermore, this legislation contains object clauses.³⁰ In some cases there are well-documented non-legislative pronouncements on the policy behind the legislation, another element of the current proposal.³¹

B *Limitations of Parliamentary Sovereignty*

In any event, it may be time to question the limits of the notion of parliamentary sovereignty, at least in the context of the relationship between Parliament and the courts. The notion that Parliament is the sovereign law making was adopted into Australia from the United Kingdom, where the principle had evolved over centuries of struggle between Parliament and the Crown. Initially there was little to distinguish between a judgment and a statute and it can be argued that the acceptance of the superiority of Parliament over the judiciary was simply an historical accident.³² Parliament's dominance over the judiciary is certainly less developed in non-common law countries.³³

The notion of parliamentary sovereignty, including its sovereignty over the courts, was articulated by the famous constitutional lawyer A V Dicey in the late 19th century.³⁴ He explained it as Parliament having the right to make laws and no other person or body having the right to override the legislation of Parliament. Thus it is that with the stroke of a pen Parliament can override centuries of judge-made law.

It is not my purpose to attempt to argue against the doctrine that Parliament should be sovereign over the judiciary. Rather, I wish to highlight that there was no oracle from high that mandated this outcome: the hierarchical relationship simply evolved.³⁵ There may be good reason for this in our system of democracy with Parliaments elected by the people and the judiciary merely appointed by the Executive. However this assumes that parliamentarians serve a higher purpose than judges. The public choice theory of the legislative process suggests that politicians act for self-interested purposes — that is to be re-elected. It might be argued that (non-elected) judges are less likely to be influenced by self-interest and so potentially are more representative. Of course, they may still harbour ambitions (for example, to be appointed to the High Court or as a Governor or Governor-General) and seek further power, prestige and influence which might dictate their leanings.³⁶ What I am proposing here is not a realignment of the hierarchy but simply the recognition that where the legislation is ambiguous or silent then the

³⁰ See, eg, ss 602 (takeovers) and 435A (voluntary administration) *Corporations Act 2001* (Cth).

³¹ Such as the Eggleston Committee principles in the context of takeovers: Commonwealth, *Second Interim Report to the Standing Committee of Attorneys-General: Disclosure of Substantial Shareholdings and Takeovers*, Parl Paper No 43 (1969) 6.

³² See, eg, Gary Heilbronn et al, *Introducing the Law* (5th ed, 1996) especially 35-38.

³³ In these jurisdictions, the balance of power is probably closer to a partnership, see Grbich, above n 28.

³⁴ A V Dicey, *Introduction to the Law of the Constitution* (9th ed, 1950), especially 60-1.

³⁵ The sovereignty of Parliament over the judiciary probably evolved because in the history of the legal system the dispensing of justice was a role initially undertaken by the Monarch which was subsequently delegated to the courts.

³⁶ See Richard A Posner, *Overcoming Law* (1995) 118; contrast R B Korobkin and T S Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88 *California Law Review* 1051.

judiciary should make law by reference to an express policy analysis, rather than pretend to divine Parliament's intention from the words of the legislation. Parliament remains empowered to subsequently overrule the judiciary with amending legislation.

C Making Policy-based Decisions

It would also be naïve not to appreciate that in many cases judges do, in fact, decide cases by reference to underlying economic and social values, either consciously or sub-consciously. Few are prepared to articulate exactly what they are doing but rather they appear constrained to veil their decision behind the orthodoxy that they are really just identifying Parliament's intention from the words of the Statute. The proposed approach would liberate the judiciary to be open and frank as to the basis for a decision and, indeed, encourage some self-reflection. Such transparency can only further our pursuit of a just and consistent legal system that complements our economic and social agenda.

There are also those who might suggest that deciding cases on principles of public finance is no less problematic than using traditional legal reasoning with all its flaws. This writer is no apologist for economics, however I argue that the express reference to underlying economic and social policies by judges is a step in the direction of more transparent decisions and proceeds from a more acceptable basis, namely, what is best for the country rather than what is the best guess at what the words of the legislation mean. Everyday the government makes decisions for the country based on public finance theory. Certainly, there is still room for political decisions to be made based on a hidden agenda justified by reference to some doubtful public finance equation but at least one layer of subterfuge is removed.³⁷ In other words, whilst public finance theory is no magic bullet it is, in the writer's opinion, an improvement on the current system.

This is, indeed, the path eloquently advocated by Yuri Grbich as long ago as 1980.³⁸ Whilst Grbich took the view then that the current model of judicial decision making in tax cases was clearly inadequate and that there was no need to demonstrate this,³⁹ I am not so convinced that this is well appreciated. Hence my discussion of *Hart* here.

Grbich proposed a model where judges articulated the social and economic values behind their decisions. Whilst this model was based on welfare economics he acknowledged the limitations of economic theory but suggested that at least it put the values at play in sharper focus even if it was not a complete solution. A primary device to be used to rationalise decisions was the Pareto optimality principle, namely a decision might be preferred where it improved the condition of those who gained by more than those who lost.⁴⁰ Similarities with the writer's more simplistic

³⁷ There are two main theories seeking to explain the legislative process, namely public interest theory (that legislation is enacted with the public interest in mind) and public choice theory (that legislation is enacted with politicians' and others' self-interest in mind). For an overview of these see W Eskridge, P Frickey and E Garrett, *Legislation and Statutory Interpretation* (2000). For a critical appraisal of the public interest theory and one strand of public choice theory in the context of the US income tax see D Shaviro, 'Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s' (1990) 139 *University of Pennsylvania Law Review* 1.

³⁸ Yuri Grbich, 'Is Economics Any Use To Tax Lawyers' (1980) 12 *Melbourne University Law Review* 340.

³⁹ Ibid 354. Grbich states that "[t]he old closed rule model is so tattered that it threatens to undermine the credibility of legal dispute mechanisms."

⁴⁰ This was not to deny a role for distributional preferences and other justice reasons in rationalising decisions but these were to be expressly acknowledged: *ibid*, 345–6.

‘what is best for the country’ criterion are clear. Grbich accepted that his new model would require lawyers to be better tooled up to engage in economic analysis.⁴¹

Twenty four years later, Grbich derives support for a judicial decision making model focused on public policy imperatives from the European experience. This time he calls on Australian tax teachers to contribute to the development of a culture of accountability by judges by being prepared to criticise the judiciary in how they deal with policy and principles when making decisions. Furthermore, principles and legal philosophy should be at the heart of the teaching of taxation law.⁴² After criticising ‘sterile definitional debates’ in tax decisions, he suggests that a more principled approach would ‘prevent fundamental principles from being submerged in a self-justifying spiral of mindless technical analysis feeding on itself.’⁴³ And later he describes the result of the current methodology as ‘barren verbal analysis and technical minutiae wag[g]ing the policy dog.’ In his view ‘we must not suffer the hijacking of core policy decisions by low-level debates about words in a vacuum or the exercise of judicial discretion hidden behind a jungle of complexity.’⁴⁴

The judgments in *Hart* unfortunately provide the perfect illustration of what Grbich is speaking about.

IV CONCLUSION

My analysis of the costs and benefits of the *Hart* case illustrates that the resolution of tax disputes imposes a huge cost on the community. I argue that we are not are we obtaining value for our investment.

The application of traditional legal reasoning to the interpretation of obscure tax legislation does not pass a cost-benefit analysis. This reasoning seeks to identify Parliament’s intention from the words of the legislation. However, typically in difficult cases Parliament’s intention can not be discerned and the judges’ best guess results in recourse to doubtful rhetorical devices in an effort to justify the conclusion reached. Slavish adherence to the fallacy that the ‘correct’ meaning of the legislation is there to be ultimately divined by the judiciary can lead to sub-optimum outcomes and precedents that do not provide the community with any certainty. This failure of the system is then destined to repeat itself.

In such cases, I recommend that courts embrace an approach that acknowledges the inherent uncertainty of language and seeks to establish a precedent based on desirable policy objectives. This would necessitate mechanisms to assist the courts in identifying the various policy objectives behind the legislation and some protections to ensure that justice is done between the parties in the case at hand. Some image marketing of the tax system to address negative public perceptions and encourage a consideration of wider socio-economic factors by taxpayers and advisers alike might also be desirable.

In the absence of a new approach the tax system will continue in its trajectory towards greater complexity and uncertainty. Ultimately it will become the subject of public condemnation and ridicule, the first signs of which, we may already be witnessing.

⁴¹ Ibid 349.

⁴² Grbich, above n 28, especially 152 – 154.

⁴³ Ibid 143.

⁴⁴ Ibid 153. Here, Grbich also suggests the need to strengthen other delegated tax decision-making institutions, including an agenda setting and implementation capacity which spans political and bureaucratic decision-making. This has a correlation with the author’s proposal for the establishment of a tax policy committee.

NEW TAX LAWS TO DETER PROMOTERS OF TAX EXPLOITATION SCHEMES

RACHEL TOOMA*

The recently enacted Australian promoter penalty provisions aim to reform old taxes in order to address new world economic and social developments. Such developments include empirical evidence linking investment by taxpayers in tax exploitation schemes to the activities of promoters. In order to assess the effectiveness of the promoter penalty provisions as a means of reforming old law, this paper will critically examine the promoter penalty provisions. It then compares the approach of the promoter penalty provisions to the approach of other jurisdictions to promoters of tax exploitation schemes, including New Zealand, Canada, the United States and the United Kingdom.

I INTRODUCTION

Legislation aimed at deterring the promotion of tax exploitation schemes was recently enacted into Division 290 of sch 1 of the *Taxation Administration Act 1953* (Cth) ('TAA').¹ This article examines the promoter penalties as an example of legislation reforming old tax laws for a new world.

In the new world, promoters entice taxpayers to invest in schemes which taxpayers may otherwise be unaware of. Investment by some taxpayers in such schemes incites investment by a broader group of taxpayers who are concerned to keep up with the initial investors. It therefore appears that the supply of tax schemes is a driver of tax avoidance and tax evasion. The promoter penalty provisions presume that the old law, including criminal sanctions and consumer protection legislation, is limited in its ability to deter promoters from supplying schemes, and addresses these limitations by proposing a new civil penalty regime.

The article will critically examine the civil penalty regime in order to determine whether it may be expected to overcome the problems with the old law. Technical problems with the promoter penalty provisions are examined. It is also necessary to examine the new laws to deter promoters that have been enacted in other jurisdictions. The paper compares the merits of Australia's civil penalty regime to the tax shelter disclosure requirements which exist in the United States ('US'), Canada and the United Kingdom ('UK'). It also examines the lessons for the regime from the experiences of other jurisdictions, in particular, New Zealand, which has a similar civil penalty regime to the new Australian regime.

II PROBLEMS WITH THE OLD LAW

A Addressing the Supply Side of Aggressive Tax Arrangements

Tax avoidance and tax evasion are not new developments; both have existed throughout the history of taxation. However, the scale of tax avoidance has significantly increased in recent

* BA, LLB (Hons) (Macquarie), LLM (UNSW); Lecturer, Atax, University of New South Wales.

¹ *Tax Laws Amendment (2006 Measures No 1) Act 2006* (Cth), amending *Taxation Administration Act 1953* (Cth) ('TAA').

decades, perhaps for varied reasons.² Braithwaite has recently concluded that the waves of aggressive tax schemes in Australia were initially supply- driven.³ Promoters employed by financial institutions and 'Big Four' accounting firms have created schemes for 'big end of town' taxpayers. This has, in turn, created a demand for aggressive tax planning opportunities from a larger group of taxpayers who do not want to miss out on the schemes used by the 'big end of town'.

Recent research has confirmed that many taxpayers rely on tax advisors for tax avoidance schemes of which they would otherwise be unaware.⁴ A survey of taxpayers reviewed by the Australian Taxation Office ('ATO') concerning the involvement in tax avoidance schemes found that most investors got the idea to invest in tax schemes from financial advisors and tax professionals.⁵

Recent studies have therefore recommended that some responsibility for tax exploitation schemes be placed on promoters of the schemes.⁶ Braithwaite identifies some key strategies to address tax avoidance, which include the imposition of promoter penalties, and instituting tax shelter disclosure rules.⁷ A Senate Report recommended that the ATO be provided with the necessary powers to enable it to apply to the courts for injunctive relief to prevent sales of mass-marketed schemes.⁸ A need to address the supply side of aggressive tax arrangements was also identified by the First Assistant Commissioner in a paper presented at the Centre for Tax System Integrity Third International Research Conference in July 2003.⁹

In December 2003, the federal Treasury first announced its intention to introduce measures to deter the promotion of tax exploitation schemes. The Explanatory Memorandum to the *Tax Laws Amendment (2006 Measures No 1) Bill 2006* (the 'Explanatory Memorandum') clearly indicated that the aim of the regime was to impose a direct financial risk upon promoters and implementers — in addition to providing injunctive measures enabling the Commissioner to stop the promotion of a scheme — so as to limit the widespread promotion of tax exploitation schemes.¹⁰

B Limitations of Existing Means of Deterrence

Under the old law, the means of deterring promoters of tax exploitation schemes was limited to criminal prosecutions; consumer protection legislation; civil suits brought by the taxpayer against the promoter; legislation applying to tax agents; and professional standards. These are briefly discussed in this section.

1 Criminal Prosecutions

Promoters of tax exploitation schemes may be guilty of an offence of aiding and abetting under the *Crimes (Taxation Offences) Act 1980* (Cth) or the *Criminal Code*. The difficulty with using

² C Evans, 'Avoiding the Issue: Countering the Termites in the Australian Tax System – A Review of *Markets in Vice Markets in Virtue* by John Braithwaite' *Australian Review of Public Affairs*, 12 September 2005, <<http://www.australianreview.net>>.

³ J Braithwaite, *Markets in Vice Markets in Virtue* (2005).

⁴ K Murphy, 'Aggressive Tax Planning: Differentiating Those Playing the Game from Those Who Don't' (2004) 25 *Journal of Economic Psychology* 307, 308.

⁵ K Murphy, 'An Examination of Taxpayers' Attitudes towards the Australian Tax System: Findings from a Survey of Tax Scheme Avoiders' (2003) 18(2) *Australian Tax Forum* 209.

⁶ *Ibid.*

⁷ Braithwaite, above n 3.

⁸ Senate Economics Reference Committee, Parliament of Australia, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection* (February 2002) recommendation 1.30.

⁹ K Fitzpatrick, 'The Australian Tax Office's Approaches to Aggressive Tax Planning' (Paper presented at the Centre for Tax System Integrity Third International Research Conference, Canberra, 24–25 July 2003).

¹⁰ Explanatory Memorandum, para [3.136].

these provisions as a deterrent for promoters of tax exploitation schemes is that a criminal burden of proof must be satisfied. This may mean that the ATO will only seek prosecutions in the most serious cases. If promoters are aware of this practice, they may persist with promoting tax exploitation schemes in the belief that the ATO will not prosecute offences.

2 Consumer Protection Legislation

Section 52 of the *Trade Practices Act 1975* (Cth) prohibits a corporation from engaging in conduct that is misleading or deceptive. A promoter may mislead a taxpayer into believing that a scheme is compliant with the taxation legislation when in fact it is not. In order to establish a breach of s 52, the Australian Competition and Consumer Commission ('ACCC') must demonstrate that the person affected (the taxpayer) was induced to act by the corporation's (the promoter's) conduct. The ACCC may have difficulties in establishing a breach of s 52 as the promoter must be a corporation and the taxpayer must have been induced to avoid tax by the promoter.¹¹

3 Tax Agents

Section 251M of the *Income Tax Assessment Act 1936* (Cth) ('ITAA36') imposes a statutory duty of care on registered tax agents.¹² The effect of s 251M is to make the registered tax agent liable to pay to the taxpayer any fine or other penalty to which the taxpayer is liable on account of the registered tax agent's negligence. The limitation of this provision as a means of deterring the promotion of tax exploitation schemes is that it will only apply where the promoter is a registered tax agent.

4 Professional Standards

The Institute of Chartered Accountants in Australia ('ICAA') and Certified Practising Accountants Australia ('CPA') have issued the *Statement of Taxation Standards (APS 6)* containing compulsory rules for members of those organisations. Relevantly, paragraphs 23–28 are concerned with 'Tax Arrangements'. Paragraph 26 prohibits a member from promoting or assisting in the promotion of any schemes or arrangements which have no commercial justification other than the avoidance of tax through exploitation of the revenue laws. The *APS 6 Statement* does note, however, that the prohibition is particularly directed at the marketing of artificial and contrived schemes to the general public and does not preclude a member from advising clients on schemes and arrangements.¹³ The ICAA and CPA also prohibit members from having any financial interest in any business organisation which promotes tax schemes or arrangements.¹⁴ However, like s 251M, professional standards are limited by the fact that they apply only to members governed by the standards.

5 Civil Suits Brought by Clients of Promoters

Where a taxpayer is found to have evaded or avoided tax, clients of promoters may bring an action against the promoter in either tort or contract.¹⁵ An action in contract may be brought on the basis that the promoter breached an implied contractual obligation to exercise reasonable

¹¹ V A Morfuni, 'The Civil Liability of Tax Advisers' (2005) 34 *Australian Tax Review* 131, 144.

¹² *Ibid.*, 146.

¹³ ICAA and CPA, *Statement of Taxation Standards (APS 6)* [27] ('*APS 6 Statement*').

¹⁴ *Ibid.*, [28].

¹⁵ *Ibid.*

skill and care. An action in tort may require the taxpayer to establish that the promoter was negligent. The main limitation of civil suits brought by clients of promoters is that the time and cost to a taxpayer, particularly a taxpayer which is required to pay taxes with penalties and interest, may be prohibitive.

Tax avoidance cannot be said to be caused entirely by the supply by promoters of tax exploitation schemes; there must also be a demand by taxpayers for the schemes.¹⁶ However, the link between promoters and investment by taxpayers in tax exploitation schemes, and the limitations with the existing means of deterring the promotion of tax exploitation schemes, suggest that the old law may fail to adequately address the supply of tax exploitation schemes. It appears that there is a need for a new regime for deterring tax scheme promoters. The issue then, is one of assessing whether the recently enacted civil penalty regime is the appropriate new world response to the promotion of tax exploitation schemes.

III NEW LAW

The *Tax Laws Amendment (2006 Measures No 1) Act 2006* (Cth) introduced new Division 290 into schedule 1 of the *TAA*. Section 290–50 prescribes the conduct to which the civil penalty regime would apply. Section 290–50(1) provides that an entity must not engage in conduct that results in that or another entity being a promoter of a tax exploitation scheme. There are three methods of deterring the promotion of tax exploitation schemes under the new civil penalty regime: civil penalties, statutory injunctions and voluntary undertakings.

A Civil Penalties

The maximum civil penalty applying to individuals who breach s 290–50(1) is the greater of 5000 penalty units (currently \$550 000) or twice the consideration received for the tax exploitation scheme.¹⁷ The maximum civil penalty applying to bodies corporate is the greater of 25 000 penalty units (currently \$2.75 million) or twice the consideration received for the tax exploitation scheme.¹⁸

Section 290–50(5) prescribes the principles to which the Federal Court of Australia must have regard when deciding the appropriate penalty for a breach of s 290–50(1).¹⁹ A civil penalty payable to the Commonwealth²⁰ must be ordered by the Federal Court following an application by the Commissioner that an entity has contravened s 290–50(1),²¹ subject to a number of exceptions listed in s 290–55.²²

While the policy arguments for linking the value of the civil penalty to the financial gain to the promoter of the scheme are clear,²³ it is unclear how the Commissioner will calculate ‘the consideration received or receivable (directly or indirectly) by the entity and associates of the

¹⁶ Evans, above n 2.

¹⁷ *TAA* s 290–50(4).

¹⁸ *TAA* s 290–50(4).

¹⁹ These include: the amount of the consideration received or receivable (directly or indirectly) by the entity and associates of the entity in respect of the scheme; the deterrent effect that any penalty may have; the amount of loss or damage incurred by scheme participants; the nature and extent of the contravention; the circumstances in which the contravention took place, including the deliberateness of the entity’s conduct and whether there was an honest and reasonable mistake of law; the period over which the conduct extended; whether the entity took any steps to avoid the contravention; whether the entity has previously been found by the Court to have engaged in the same or similar conduct; and the degree of the entity’s cooperation with the Commissioner.

²⁰ *TAA* s 290–50(6).

²¹ *TAA* s 290–50(3).

²² Exceptions are divided into five categories: reasonable mistake or reasonable precautions; reliance on advice from the Commissioner; time limitation; exception where entity does not know result of conduct; and employees.

²³ See, eg, Braithwaite, above n 3, 200, where he concludes that ‘[i]t is inconceivable that promoter penalties could ever be heavy enough to deter the rewards of contingency fees’.

entity in respect of the scheme'.²⁴ Such a calculation may be possible in jurisdictions requiring tax shelter disclosure. However, where there are no disclosure requirements, it is difficult to anticipate how the Commissioner will, in practice, assess the consideration that a promoter receives in respect of a scheme, for the purpose of imposing a financial penalty on the promoter.

It would perhaps have been preferable to apply a flat rate penalty to promoters, for example, 5000 penalty units for individuals and 25 000 penalty units for bodies corporate. In order to address a situation where the civil penalty is insubstantial compared to the financial gains to the promoter from the tax exploitation scheme, the Federal Court could perhaps also have been granted discretion to order the promoter to meet with a delegate of the Commissioner at certain periods. A promoter and Commissioner meeting should be required as a matter of course where the Federal Court has imposed a civil penalty upon the promoter on more than one occasion. The meeting may result in the delegate of the Commissioner referring schemes of concern to the relevant ATO task-forces, or may involve the delegate requiring the promoter to implement an education program for its clients on the consequences of tax avoidance and tax evasion.

B Statutory Injunctions

Under Subdivision 290–C, the Commissioner may seek an injunction from the Federal Court where an entity has engaged, is engaging, or is proposing to engage in conduct that would trigger the civil penalty provisions. The Explanatory Memorandum describes statutory injunctions as having a 'real time' impact in that they can stop the promotion of schemes before investors participate. It further notes that statutory injunctions can be used in addition to civil penalty proceedings where both injunctive relief and a civil penalty award are considered to be warranted.²⁵ The powers conferred on the Federal Court under Subdivision 290-C are supplementary to the Court's other powers.²⁶ Injunctions may be for the purpose of restraining an entity from engaging in particular conduct,²⁷ or for the purpose of requiring an entity to do something.²⁸ The Federal Court may also grant interim injunctions before considering an application for an injunction.²⁹

There are at least two interesting aspects to Subdivision C. First, under the draft promoter penalties legislation released for public comment in August 2005, the Commonwealth was not required to give the Federal Court an undertaking as to damages when seeking an interim injunction.³⁰ This provision was removed from the promoter penalty provisions as enacted under the *Tax Laws Amendment (2006 Measures No 1) Act 2006*.

Prior to the release of the legislation as enacted, one commentator described the provision excusing the government from the requirement of providing an undertaking as to damages as 'a highly objectionable interference with common law principles'.³¹ The commentator argued that if the Commissioner is convinced that there is a case for an interim injunction, then the Commissioner should bear the risk of costs if later proven to be incorrect.³² The explanatory memorandum to the exposure draft bill stated that the undertaking as to damages should not have

²⁴ TAA sch 1 s 290–50(4)(b).

²⁵ Explanatory Memorandum, para [3.79].

²⁶ TAA sch 1 s 290–150.

²⁷ TAA sch 1 s 290–145(1).

²⁸ TAA sch 1 s 290–145(2).

²⁹ TAA sch 1 s 290–130.

³⁰ *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005* (Cth) cl 72 and cl 73.

³¹ C Bevan, 'Tax Scheme Promoters Draft Bill: some difficulties' (Pt 2) (November 2005) 48 *ATP Weekly Tax Bulletin*, para 1892.

³² *Ibid.*

been required because the Commissioner would be acting in the public interest;³³ that is, the Commissioner's intent in applying the civil penalty regime is to protect the interests of taxpayers, the public revenue, and the integrity of the tax system.

Injunctive powers of government authorities in the area of occupational health and safety appear to support the policy position of the exposure draft bill. For example, s 93 of the *Occupational Health and Safety Act 2000* (NSW) allows an inspector to issue a prohibition notice in relation to a place of work where there is occurring or about to occur, any activity which involves or will involve an immediate risk to the health or safety of any person. The notice prohibits the carrying on of the activity until the matters which give, or will give rise to the risk, are remedied. Section 94 further provides that a person who, without reasonable excuse, fails to comply with a requirement imposed by a prohibition notice is guilty of an offence. The statute provides a process for a review of the inspector's decision to issue a prohibition notice: an application for a review may be made to WorkCover³⁴; and an appeal may be made from the WorkCover decision to a Local Court constituted by an Industrial Magistrate sitting alone.³⁵

The prohibition notice is very similar to an injunction, in that it prevents an entity from continuing the conduct of its business. The inspector does not need to seek court approval prior to issuing a prohibition notice, and the review and appeals process available to recipients of prohibition notices may be costly and time consuming. The broad powers of inspectors under the NSW occupational health and safety legislation demonstrate that the provision which existed under the exposure draft Bill, that the Commissioner need not give an undertaking as to damages, is not an unprecedented interference with common law principles. Rather, where the Commissioner would seek an injunction against an entity considered to be a promoter, the promoter would have been given an opportunity to appear before the Federal Court. On the other hand, the entity that is issued a prohibition notice under occupation health and safety legislation must comply with the notice, or otherwise seek a review by WorkCover, and possibly also appeal to the Industrial Magistrate.

It is submitted that the public interest in deterring the promotion of tax exploitation schemes was perhaps significant enough to warrant a provision exempting the Commissioner from providing an undertaking as to damages. Arguably, the abandonment of the exception to the damages undertaking in the promoter penalty provisions that were recently enacted is harmful to the success of the new provisions as a means of addressing the old world problem of the promotion of tax exploitation schemes.

The second interesting point about the statutory injunction provisions is the limitation imposed on the Commissioner in seeking an injunction where a product ruling request is pending.³⁶ Section 290–135 provides that if an entity has made a written application for a product ruling in relation to a scheme and the Commissioner has neither made the ruling nor told the entity in writing that the Commissioner has declined to make the ruling, then the Commissioner cannot make an application for an injunction under s 290–125 until the Commissioner either makes a ruling or advises in writing that he declines to do so. The rationale for this provision is set out in the Explanatory Memorandum, which asserts that the promoter is not at risk of penalty merely as a result of delays in the ATO processing a request for a product ruling.³⁷

³³ *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005* (Cth), cl 73.

³⁴ *Occupational Health and Safety Act 2000* (NSW) s 96.

³⁵ *Occupational Health and Safety Act 2000* (NSW) s 97.

³⁶ TAA sch 1 s 290–135.

³⁷ Explanatory Memorandum, para [3.84].

The problem with s 290–135 is that it appears to be at odds with the stated policy aim of the promoter penalty provisions: to achieve symmetry in penalty regimes for promoters and taxpayers.³⁸ Under s 290–135, an injunction cannot be sought against the promoter to prevent the promotion or implementation of a scheme prior to the Commissioner deciding a product ruling, whereas a taxpayer investing in the scheme during this period may be subject to any relevant penalties applying to the taxpayer. It is curious, given the aim of s 290–135, that the promoter penalty provisions do not instead prevent the Commissioner from seeking civil penalties while a ruling is pending.

C Voluntary Undertakings

Subdivision 290–D of sch 1 of the TAA allows the Commissioner to accept a written undertaking given by an entity for the purposes of furthering the objectives of the Division.³⁹ The Commissioner cannot compel an individual to give an undertaking, and the Commissioner cannot be compelled to accept an undertaking.⁴⁰ However, if an undertaking is given, and the Commissioner considers that the entity that gave the undertaking has breached any of its terms, the Commissioner may apply to the Federal Court for an order directing the entity to comply with that term of the undertaking, and/or any other order that the Court considers appropriate.⁴¹

The Explanatory Memorandum states that the benefits of voluntary undertakings arise from their flexibility. Voluntary undertakings allow the Commissioner to tailor enforcement responses to individual circumstances and may provide a more timely and cost-effective response than Court orders.⁴² The explanatory memorandum to the exposure draft bill provided two examples of where the Commissioner may accept a voluntary undertaking, which were not included in the Explanatory Memorandum to the Bill which introduced Division 290.⁴³ The first example related to financing arrangements of a scheme, where an undertaking may require a promoter or scheme implementer to change incorrect statements or include statements such as ‘the Tax Office has advised that it does *not* endorse this view’. In the second example, it is suggested that voluntary undertakings be used as a preliminary step to prevent an individual from implementing an arrangement in a way that is materially different to the terms of its product, or other binding ruling.

Interestingly, the Explanatory Memorandum does not anticipate voluntary undertakings requiring public advertisements, for example, the publication of advertisements in newspapers advising the public of a breach of Division 290 by the entity promoting a tax exploitation scheme. This may be because it is unlikely that the promoter would agree to such an undertaking. However, the promoter penalty provisions and Explanatory Memorandum are both silent on the issue of whether the Commissioner will require the publication of voluntary undertakings. The Explanatory Memorandum does note that a voluntary undertaking can be made without either party admitting any liability.⁴⁴

It may be, then, that deterrence through publicity orders was not the policy intent of the legislation. However, it is submitted that publicity orders may serve to deter the promotion of tax

³⁸ Ibid, para [3.136].

³⁹ TAA sch 1 s 290–200(1).

⁴⁰ Explanatory Memorandum, para [3.93].

⁴¹ TAA sch 1 s 290–200(3) and (4).

⁴² Explanatory Memorandum, para [3.91].

⁴³ Explanatory memorandum to *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005* (Cth), para [87].

⁴⁴ Explanatory memorandum to *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005* (Cth), para [3.94].

exploitation schemes — and as promoters may be reluctant to enter into such undertakings — a fourth category of civil penalty, publicity orders, may have been beneficial.

D What role will the General Anti-Avoidance Rule ('GAAR') Panel play?

It has been noted that an aim of the promoter penalty provisions was to create a penalty regime that mirrors the penalties faced by taxpayers.⁴⁵ It is submitted then, that promoters ought to be afforded similar rights and protections, with respect to Division 290 of sch 1 of the *TAA*, to those that are available to taxpayers who have invested in tax exploitation schemes.

Practice Statement PS LA 2005/24, entitled 'Application of General Anti-Avoidance Rules', explains that the Commissioner has established a GAAR Panel to advise on the application of GAARs (eg, Part IVA of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA36*') and Division 165 of the *A New Tax System (GST) Act* (Cth)) to particular arrangements. The stated primary purpose of the Panel is to assist the Tax Office in its administration of the GAARs by helping to ensure that the rules are applied objectively, and that a consistent approach is taken to issues regarding their application.⁴⁶

To assist the Panel in providing advice to the Commissioner, a taxpayer is usually invited to attend a Panel meeting and address the Panel.⁴⁷ Practice Statement PS LA 2005/24 specifically notes that where an arrangement involves numerous taxpayers in similar circumstances, promoters or facilitators of the arrangement may be invited to address the Panel.⁴⁸ Promoters and facilitators should also be afforded the right to make submissions to any Panel established by the Commissioner for the purposes of determining whether the Commissioner should seek to apply Division 290.

E Technical Problems with the New Law

During the consultation period, numerous industry submissions were made cautioning that the promoter penalty provisions have the potential to interfere with ordinary commercial transactions. Such cautioning often focused upon the legislative definitions of 'promoter' and 'tax exploitation scheme'. While some amendments were made to address the concerns expressed, many would still argue that there are technical problems with the recently enacted definitions.

1 Definition of 'Promoter'

Section 290–60 of sch 1 of the *TAA* provides a definition of 'promoter':

- (1) An entity is a promoter of a tax exploitation scheme if:
 - (a) the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
 - (b) the entity or an associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
 - (c) having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.
- (2) However, an entity is not a promoter of a tax exploitation scheme merely because the entity provides advice about the scheme.

⁴⁵ Explanatory Memorandum, [3.136].

⁴⁶ PS LA 2005/24, [23].

⁴⁷ *Ibid* [31].

⁴⁸ *Ibid* [34].

- (3) An employee is not taken to have had a substantial role in respect of that marketing or encouragement merely because the employee distributes information or material prepared by another entity.

The exposure draft bill referred to a promoter as including an individual ‘implementing’ a tax exploitation scheme. The use of an undefined term, ‘implementing’, was widely criticised as giving rise to uncertainty for tax advisers.⁴⁹ While the explanatory memorandum to the exposure draft bill indicated that a civil penalty would not apply to practitioners who merely provide tax advice, the draft bill itself was less precise.⁵⁰ It appears that concern relating to the use of the term ‘implements’ has been addressed by the recently enacted legislation, where a ‘promoter’ is not defined by reference to a person implementing a tax exploitation scheme.

A further criticism of the exposure draft bill related to a note attached to the definition of promoter, which appears to have been directed at excluding advisers from the definition.⁵¹ It was argued that, without the note, it may have been clear that an individual advising was not a ‘promoter’. However, the exception may have captured an adviser if the adviser is considered to have been ‘encouraging or helping entities to enter into the scheme’ (to use the language of the note): for example, by concluding that the scheme is effective.⁵² As may be observed from the above definition, the note was removed in the recently enacted legislation.

Despite these changes to the exposure draft bill aimed at preventing tax advisers from being treated as promoters, concern has been expressed that the recently enacted provisions may still unintentionally apply to advisers.⁵³ Section 290–50(1) provides that ‘[a]n entity must not engage in conduct that results in that or another entity being a promoter of a tax exploitation scheme’. Accordingly, a lawyer who merely advises a financial planner that a product is tax effective, may not be within the definition of ‘promoter’. However, if the financial planner, after receiving the lawyer’s advice, then contacts clients for the purpose of selling the product to them, the lawyer may have contravened s 290–50(1) by encouraging the financial planner to be a promoter of a tax exploitation scheme.⁵⁴

It remains to be seen whether the definition of ‘promoter’ sufficiently excludes tax advisers, as the Explanatory Memorandum indicates was the intention.⁵⁵ However, it would appear that there are steps that advisers may take in order to fall outside of the scope of the civil penalty provisions. For example, advisers may require clients to provide a statutory declaration as a condition of engagement, stating that the advice provided will not be circulated for the purpose

⁴⁹ Sir Anthony Mason, Speech delivered at the book launch of R Fisher and M Walpole (eds), *Global Challenges in Tax Administration* (Fiscal Publications, Birmingham, UK, 1st edition), Sydney, 18 August 2005.

⁵⁰ Explanatory memorandum to *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005* (Cth), [21]–[35].

⁵¹ The definition of ‘promoter’ under the exposure draft bill provided as follows:

An individual is a promoter of a tax exploitation scheme if:

- (a) the individual promotes the scheme by implementing it, advancing it or encouraging growth or interest in it; and
- (b) the individual or an associate of the individual receives (directly or indirectly) consideration in respect of the scheme; and
- (c) having regard to all relevant matters, including the extent of the individual’s participation in the management of the scheme, it is reasonable to conclude that the individual has had a substantial role in promoting the scheme.

Note: However, an individual is not a promoter of a tax exploitation scheme merely because the individual provides advice about the consequences of entering into a scheme (as opposed to encouraging or helping entities to enter into the scheme).

⁵² M Leibler, ‘Government Crackdown on Tax Exploitation Schemes – Are Tax Advisers at Risk?’ (August 2005) 35 *ATP Weekly Tax Bulletin*.

⁵³ Unintentionally because the Explanatory Memorandum has been drafted on the basis that civil penalties only apply to a promoter: see D Williams, ‘Promoter Penalties’ (Paper presented at the Tax Institute of Australia seminar on promoter penalties, Sydney, 21 March 2006, paras [13.4]–[13.5].

⁵⁴ *Ibid.*

⁵⁵ Explanatory Memorandum, *Tax Laws Amendment (2006 Measures No 1) Bill 2006* (Cth), [3.49–3.50]. Paragraph 3.50 provides: ‘Advisers who advise on tax planning arrangements, even those who advise favourably on a scheme later found to be a tax exploitation scheme, are not at risk of civil penalty to the extent that they have merely provided independent, objective advice to clients’.

of promoting the particular scheme. More obviously, advisers may need to be more scrupulous in deciding whether to accept a client.

2 Definition of 'Tax Exploitation Scheme'

As with the definition of 'promoter', the definition of 'tax exploitation scheme' differs from that contained in the exposure draft bill. The definition in the exposure draft bill provided that a scheme was a tax exploitation scheme if the entity entered into the scheme for the sole or dominant purpose of getting a scheme benefit, where the scheme benefit was not available at law. A note to the definition provided that a scheme was not a tax exploitation scheme where implementation of the scheme was in accordance with binding advice from the ATO.⁵⁶

Section 290–65 of sch 1 of the TAA has two alternative definitions of 'tax exploitation scheme', depending upon whether or not the scheme has yet been implemented. If the scheme has been implemented, it will be a tax exploitation scheme where it is reasonable to conclude that an entity that (alone or with others) entered into or carried out the scheme did so with the sole or dominant purpose of that entity or another entity getting a scheme benefit from a scheme, and it is not reasonably arguable that the scheme benefit is available at law.⁵⁷ A note to the provision provides that it would be reasonably arguable that the scheme benefit is available at law where the implementation of the scheme for all participants was in accordance with binding advice given by or on behalf of the Commissioner (the note states, if the implementation were in accordance with a public ruling or if all participants had private rulings under the TAA). Section 290–65(2) further provides that, in deciding whether it is reasonably arguable that a scheme benefit would be available at law, anything that the Commissioner can do under a taxation law may be taken into account; for example, cancelling a tax benefit obtained by a taxpayer in connection with a scheme under Part IVA of the ITAA36.

The use of the 'reasonably arguable' language and example in the recently enacted civil penalty provisions perhaps indicates that Division 290 of the TAA 53 will be exercised where the taxpayer has been found to have acted contrary to Part IVA of the ITAA 36.⁵⁸ It has been argued, in relation to Part IVA of the ITAA 36 and the administrative penalties in Division 284 of sch 1 of the TAA, that if a dominant purpose is concluded under Part IVA of the ITAA36, the dominant purpose under Division 284 should be met. This is in spite of the fact that a technical reading of Division 284 of the TAA suggests that it may produce a different conclusion to Part IVA of the ITAA36.⁵⁹ However, the Explanatory Memorandum does not indicate that the intention of the civil penalty regime is merely to apply penalties following from a finding that Part IVA of the

⁵⁶ See *Exposure Draft Tax Laws Amendment (2005 Measures No 6) Bill 2005 (Cth)*, s 290–65, which provided that a scheme is a 'tax exploitation scheme' if:

- (a) it is reasonable to conclude that an entity that (alone or with others) entered into or carried out the scheme, or part of it, did so with the sole or dominant purpose of that entity or another entity getting a scheme benefit from the scheme; and
- (b) the scheme benefit is not available at law.

A note to draft section 290–65 provided:

The condition in paragraph (b) would not be satisfied if the implementation of the scheme for all participants were in accordance with binding advice from the Australian Taxation Office. For example, if that implementation were in accordance with a public ruling under the *Taxation Administration Act 1953*, or all participants had private rulings under that Act and the implementation were in accordance with those rulings.

⁵⁷ Under TAA s 290-65, if the scheme has not yet been implemented, it will be a tax exploitation scheme if it is reasonable to conclude that, if an entity (alone or with others) had entered into or carried out the scheme, it would have done so with the sole or dominant purpose of that entity or another entity getting a scheme benefit from the scheme and, it is not reasonably arguable that the scheme benefit would be available at law if the scheme were implemented.

⁵⁸ See further Explanatory Memorandum, [3.58], which states that '[t]his approach helps ensure that promoters are generally at risk of penalties for participation in tax avoidance or evasion schemes under Subdivision 284C'.

⁵⁹ *Taxability*, 'Part IVA Practice' Information Exchange, November 2005, [11]–[30].

ITAA36 applies to a taxpayer. It states: ‘A promoter’s liability to penalty is independent of any action that may be taken against scheme participants’.⁶⁰

It may have been preferable for the definition of ‘tax exploitation scheme’ to have instead followed the definition of ‘scheme’ in Part IVA of the *ITAA36*. If the language of Part IVA were adopted, it could have been established more clearly whether a dominant purpose in relation to the civil penalty provisions requires an objective test, and as with Part IVA, there could have been a list of factors indicative of purpose.⁶¹

F Conclusions

The new civil penalty regime may be expected to be a more effective deterrent for promoters of tax exploitation schemes than the existing means of deterrence. However, notably absent from the powers available to the Commissioner under Division 290 of sch 1 of the *TAA* is the power to seek publicity orders. It is unclear whether promoters will be afforded the same opportunity as taxpayers investing in tax exploitation schemes, to appear before the GAAR Panel prior to the Commissioner seeking civil penalty orders from the Federal Court. Not specific to the new Australian legislation, there is also some uncertainty regarding the definitions of ‘promoter’ and ‘tax exploitation scheme’. At this juncture then, it is necessary to consider the approach of other jurisdictions to deterring the promotion of tax exploitation schemes.

IV COMPARATIVE ANALYSIS OF NEW LAWS DETERRING PROMOTERS OF TAX EXPLOITATION SCHEMES

New Zealand, the US, Canada and the UK have enacted legislation aimed at deterring the promotion of tax exploitation schemes.⁶² It is interesting to examine the development of these different regimes, and to compare the relevant definitions to those applying under the new civil penalty regime in Australia, in particular the definition of ‘promoter’, and the types of schemes to which the provisions relate.

A New Zealand

New Zealand has recently enacted legislation for the purpose of deterring the promotion of tax exploitation schemes.

⁶⁰ Explanatory Memorandum, para [3.65], which further provides: ‘The test of whether it is reasonably arguable that a scheme benefit is available at law is applied when the promoter’s conduct takes place, and not with the benefit of hindsight once the review and appeal rights for scheme participants have been exhausted’. Paragraph [3.66] of the Explanatory Memorandum provides: ‘When examining what is reasonably arguable at the time of the promoter’s conduct, the Federal Court may take into account anything that the Commissioner can do under a taxation law, including issuing a determination under Part IVA of the *ITAA 36* or exercising a discretion’.

⁶¹ D Williams, above n 53, [20.3–20.4].

⁶² The Victorian duties legislation was also recently amended to introduce a promoter penalty applying with respect to both transfer duty: *Duties Act 2000* (Vic) s69D; and land rich duty: *Duties Act 2000* (Vic) s 89J. Each provision is entitled ‘misleading information’, and broadly applies to a person who is:

- employed or concerned in the preparation of an instrument that effects or evidences a dutiable transaction, or the provision of any advice regarding the form of the dutiable transaction; and
- omits or fails to include in the instrument or any other material or data presented to the Commissioner any fact or circumstance affecting the liability of any person to duty.

The penalty under the provisions is 10 penalty units, which is currently \$1000. The provisions have been widely criticized, particularly as they have the potential; to apply to persons with only a remote involvement with a dutiable transaction. Various submissions by professional bodies on the amending legislation argued that a purpose test should have been included in the provisions.

1 *The Issues in New Zealand Prior to Enactment of the Promoter Penalties*

The idea of a promoter penalty was first raised in a review by the Inland Revenue Department in August 2001 ('the Review').⁶³ The rationale for the introduction of promoter penalties was not unlike that expressed in Australia. The Review noted that, while a taxpayer investing in a scheme which constitutes tax avoidance is liable to a shortfall penalty, no penalties were imposed on promoters of the scheme.⁶⁴ The Review further noted that in some cases, the offer documentation for tax schemes attempts to prevent taxpayers from taking legal action against the promoter.⁶⁵ Because the promoter is usually the party with the greater knowledge of the scheme's tax effect, the Review considered that the promoters of schemes should be accountable for their actions.⁶⁶

The Review posed three alternative options for addressing the promotion of tax schemes: increasing the penalty for investors in the tax scheme; introducing a penalty for promoters of tax avoidance schemes; and a combination of increasing investor penalties and introducing promoter penalties. The conclusion with respect to the first and third alternatives was that an increase in the level of investor penalties would result in investors facing penalties in excess of their offence, and these options were therefore considered not to be feasible.⁶⁷

Discussion of the second option, the introduction of promoter penalties, considered that penalising a scheme's promoter had the potential to reduce tax avoidance across many taxpayers by reducing the number of schemes promoted and encouraging promoters to take greater care in determining the tax impact of their schemes. Interestingly, the Review noted that one way in which promoters may take greater care in determining the tax impact of their schemes is by making increased use of binding rulings on the tax effects of the scheme.⁶⁸ It was considered that requests for binding rulings would enable any problems with the legislation to be brought to the attention of the Inland Revenue Department, and the legislation could then be amended more quickly than it otherwise may have been. To this end, it is important to note that in January 2002 the Policy Division of Inland Revenue issued a paper which recommended that certain tax schemes be required to be registered with Inland Revenue in order to efficiently obtain information on schemes.⁶⁹ However, the recommendation as to registration of tax schemes, which faced staunch opposition from tax professionals and industry groups, was never enacted into legislation.

Disadvantages of promoter penalties were also noted in the Review. First, promoter penalties were considered to have the potential to weaken the principle that taxpayers have sole responsibility for their tax return. Secondly, the penalty may not be able to be enforced in situations where a promoter uses a 'straw-man' or becomes a non-resident.⁷⁰ However, the government concluded that the introduction of a promoter penalty was the best way of ensuring that promoters are held accountable for their actions.

The Review recommended that the promoter penalty would apply if a scheme breached an anti-avoidance provision or resulted in an investor having a shortfall penalty for an abusive tax position.⁷¹ However, the imposition of the penalty would not depend on the successful imposition

⁶³ CCH, 'Promoter Penalty in Review' (October 2003) *CCH New Zealand Online Library* No 5.

⁶⁴ Inland Revenue Department, 'Taxpayer Compliance, Standards and Penalties: A Review – A Government Discussion Document' (Inland Revenue Department, August 2001) ('the Review').

⁶⁵ *Ibid* [9.1].

⁶⁶ *Ibid* [9.2]–[9.3].

⁶⁷ *Ibid* [9.9].

⁶⁸ *Ibid* [9.11].

⁶⁹ New Zealand Inland Revenue, *Mass-marketed Tax Schemes: An Officials' Issues Paper on Suggested Legislative Amendments* (2002) [4.3].

⁷⁰ Inland Revenue Department, above n 64, [9.13].

⁷¹ *Ibid* [9.16].

of a penalty on the investor.⁷² It was proposed that the penalty would be imposed at a flat rate of 39 per cent of the shortfall penalty imposed on the investor. It was considered necessary to link the penalty to the shortfall amount to ensure, on the one hand, that the penalty is not so little compared to the returns that the promoter may make from the scheme, to render the penalty as merely an expense in selling the scheme, and on the other hand, that the penalty is not excessive.

One report prepared by the Policy Advice Division of the Inland Revenue and Treasury in November 2002 responded to the concerns of tax advisors and industry bodies with respect to the draft legislation for the introduction of a promoter penalty.⁷³ Many of the concerns raised have similarly been raised in the Australian context, most notably in respect of the definition of ‘promoter’ and the scope of arrangements caught by the promoter penalty provisions; and the need for promoter penalties where criminal sanctions already exist.

Submissions with respect to the meaning of ‘promoter’ argued that, as the definition included any person who ‘is involved in formulating a plan or program from which an arrangement is offered’,⁷⁴ it would catch advisers who have not promoted the scheme. The government noted that the definition of ‘promoter’ was intentionally broad, but was concerned not to allow individuals or entities peripherally involved in a scheme to be covered by the definition. The definition was therefore amended to include persons ‘significantly involved’, rather than ‘involved’.

In order for the promoter penalties to apply under the New Zealand draft bill, it was necessary for the scheme to have been marketed to five or more persons. A submission on the draft bill by the New Zealand Law Society argued that if the legislation was genuinely intended to attack mass-marketed schemes, then a threshold of sales to 20 or more persons would be more appropriate.⁷⁵ The New Zealand Law Society considered that ‘offering an arrangement to five people, particularly if they are related to the offeror, or are the offeror’s business associates, would hardly constitute ‘mass-marketing’.⁷⁶ The government accepted the rationale of the submission but was concerned that a threshold of 20 or more may allow some promoters to avoid imposition of the penalty. The government therefore recommended 10 or more people as the threshold.

Submissions on the draft bill argued that the promoter penalties were not necessary as the government was already able to pursue promoters of tax schemes. The government rejected such submissions, noting that the existing penalty for aiding and abetting is a criminal penalty requiring a criminal standard of proof to be established. The government considered that the promoter penalties were necessary to prevent the promotion of tax schemes where the criminal standard of proof would be difficult to establish.

2 Overview of New Zealand’s New Promoter Penalties

The promoter penalty provisions are prescribed in ss 141EB and 141EC of the *Taxation Administration Act 1994* (NZ) and apply to arrangements entered into from 26 March 2003. Section 141ED provides that a ‘promoter’ of an arrangement is liable to a promoter penalty⁷⁷ if:

⁷² Ibid [9.17].

⁷³ Policy Advice Division, ‘Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials’ Report to the Finance and Expenditure Committee on Submissions on the Bill’ (Inland Revenue and Treasury, November 2002).

⁷⁴ New Zealand Law Society, ‘Submissions on Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill’, <[http://www.nz-lawsoc.org.nz/general/submissions/Taxation per cent20\(MOTC per cent20 per cent20Misc per cent20Prov\) per cent20Bill per cent201609.htm](http://www.nz-lawsoc.org.nz/general/submissions/Taxation_per cent20(MOTC per cent20 per cent20Misc per cent20Prov) per cent20Bill per cent201609.htm)>

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ *Taxation Administration Act 1994* (NZ) s 141EB(1).

- a taxpayer becomes a party to the arrangement and a shortfall penalty for an abusive tax position is imposed on the taxpayer as a result of the arrangement; and
- the arrangement is offered, sold, issued or promoted to 10 or more persons in a tax year.

‘Promoter’ is defined in section 141EC to mean:

- a person who is a party to, or is significantly involved in formulating, a plan or program from which an arrangement is offered; or
- a person who is aware of material and relevant aspects of the arrangement and who sells, issues or promotes the selling or issuing of the arrangement, whether or not for remuneration.

However, s 141EC notes that a ‘promoter’ does not include a person whose involvement with the arrangement is limited to providing legal, accounting, clerical or secretarial services to a promoter. In *Standard Practice Statement INV 290 Promoter Penalties*, the Commissioner indicates that the question of whether a person is a party to a plan or program is a factual inquiry based on factors such as the flow of money, involvement with the design of the arrangement, the person’s degree of knowledge, and documentation and any advertising or promotional material. Non-individuals may be promoters, and there may be more than one promoter in relation to an arrangement.⁷⁸

An ‘arrangement’ is broadly defined in s 3 of the *Taxation Administration Act 1994* (NZ) to mean a contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect. Section 141EB(2) notes that an arrangement is treated as being offered, sold, issued or promoted to 10 or more persons if 10 or more persons claim tax-related benefits as a result of the arrangement.

The amount of the promoter penalty is the sum of the shortfalls resulting from taking an abusive tax position for which the promoter would have been liable if the promoter had been a party to the arrangement in the place of each party to the arrangement to whom the arrangement was offered, sold, issued or promoted. A shortfall penalty for an abusive tax position occurs where the taxpayer takes an unacceptable tax position with a dominant purpose of avoiding tax, and which results in a shortfall of at least NZ\$20 000.⁷⁹

A promoter has equivalent objection rights to penalties as those of investors in tax schemes. Section 138L of the *Taxation Administration Act 1994* (NZ) provides that a taxpayer assessed by the Commissioner to a civil penalty:

- may challenge the penalty in the same way as a taxpayer may challenge the assessment of tax to which the penalty relates; and
- has the same rights and obligations, in relation to proceedings concerning the penalty, as a person has in relating to proceedings concerning the tax.

The term ‘civil penalty’ is defined in s 3 of the *Taxation Administration Act 1994* (NZ) to include a promoter penalty. Similarly, ‘taxpayer’ is broadly defined to mean a person who: is liable to perform or comply with a tax obligation, or, may take a tax position whether as principal or as an agent or officer or employee of another person, or otherwise.

While the promoter penalties are new and untested, the Inland Revenue has indicated in informal discussions that they are aware of a trend in New Zealand away from mass-marketed schemes to boutique schemes with less than ten investors, which would avoid the promoter penalties.

⁷⁸ CCH, above n 63.

⁷⁹ Ibid.

B Canada

1 Third Party Civil Penalties

Third party civil penalties commenced in Canada from 29 June 2000.⁸⁰ The penalties were intended to deter tax shelter or tax shelter-like promotions with faulty or inflated assumptions.⁸¹ The penalties were aimed at two main sources of abuse: tax promoters who devise schemes which result in unwarranted claims for deductions ('planning penalties'); and tax return preparers who manufacture deductions ('preparer penalties').⁸²

Broadly, planning penalties may apply to an individual, a corporation or an entity⁸³ that makes or furnishes, participates in the making, or causes another to make or furnish a statement that the person knows is a false statement, in the course of a planning activity.⁸⁴ A 'planning activity' is defined to mean:

- organising or creating, or assisting in the organisation or creation of, an arrangement, an entity, a plan or a scheme; and
- participating, directly or indirectly, in the selling of an interest in, or the promotion of, an arrangement, an entity, a plan, a property or a scheme.

The Canadian planning penalties are very different to the New Zealand 'promoter penalties'. Whereas the New Zealand penalties generally apply as a result of there being a contravention of the GAAR, the Canadian third party civil penalties are not intended to apply to arrangements by reason of a determination that they are subject to the application of the GAAR.⁸⁵ The Canadian GAAR applies if an arrangement is technically effective, and the third party civil penalties apply where the arrangement is ineffective and based on false statements.

Like the New Zealand promoter penalties, the Canadian third party civil penalties were intended to overcome the difficult burden of proof of establishing conduct of a criminal nature.⁸⁶ The penalty for a breach of s 163.2 of the Canadian *Income Tax Act* is generally CAN\$1000.⁸⁷ However if the breach of s 163.2 is the result of a false statement made in the course of a planning or valuation activity, the penalty amount is the greater of CAN\$1000 or the total of the person's gross entitlements for the planning or valuation activity.

2 Requirement for Promoters to Register Tax Shelters with the Canadian Revenue Authority

Like the US and more recently, the UK, promoters of tax shelters in Canada are required to register with the Canadian revenue authority. This registration requirement has existed in Canada since 1988.⁸⁸ Broadly, s 237.1 of the Canadian *Income Tax Act* requires the 'promoter' of a tax shelter to apply for a tax shelter identification number, and prohibits the selling of a tax shelter without an identification number. In addition, s 237.1(7) requires every promoter of a tax shelter who either accepts consideration in respect of the tax shelter, or who acts as principal or agent in

⁸⁰ Bill C-25 became law on 29 June 2000. It added s 163.2 to the *Income Tax Act*, which contains the new third party civil penalties legislation.

⁸¹ Canadian Customs and Revenue Authority, 'IC 01-1 Third Party Civil Penalties' (Canadian Customs and Revenue Authority, September 2001).

⁸² B R Carr and G Pereira, 'The Defence against Civil Penalties' (2000) 48 *Canadian Tax Journal* 1737, 1742.

⁸³ Canadian Customs and Revenue Authority, above n 81, [20].

⁸⁴ *Income Tax Act* s 163.2(2).

⁸⁵ Canadian Customs and Revenue Authority, above n 81, [77].

⁸⁶ C Campbell, 'Application of the Charter to Civil Penalties in the Income Tax Act' (2002) 50 *Canadian Tax Journal* 1, 2.

⁸⁷ *Income Tax Act* s 163.2(3).

⁸⁸ D S Ewens, C R Rinfret and A W Dunn, 'The Taxation of Corporate Reorganizations, Tax Shelter Analysis: Part 1' (1996) 44 *Canadian Tax Journal* 1207, 1207.

respect of the tax shelter in a calendar year, to file an annual information return with the revenue authority. The information return includes information about investors in the tax shelter, including the name, address and either the Social Insurance Number or Business Number of each investor. Penalties exist for failure to register a scheme and for failure to lodge the information return.

It is necessary then, to examine the definition of ‘promoter’ under the Canadian legislation. Section 237.1(1) of the Canadian *Income Tax Act* provides that a promoter in respect of a tax shelter means a person who, in the course of a business:

- sells or issues, or promotes the sale, issuance or acquisition of, the tax shelter; or
- acts as agent or adviser in respect of the sale or issuance, or the promotion of the sale, issuance or acquisition, of the tax shelter; or
- accepts, whether as a principal or agent, consideration in respect of the tax shelter; and
- more than one person may be a tax shelter promoter in respect of the same tax shelter.⁸⁹

Canadian commentators and tax professionals have noted the breadth of the definition of ‘promoter’. In particular, it has been noted that, under the definition of ‘promoter’, no investment dealer or other intermediary need be involved, but rather, a promoter may be one of two parties to a private transaction.⁹⁰ It is also clear from the definition of promoter that an adviser to a promoter would be considered a promoter.⁹¹

C US

1 Penalties for Promoters

US tax legislation prescribes certain third party civil penalties that may apply to promoters of tax shelters. Section 6700 of the *Internal Revenue Code* (‘IRC’) applies to persons promoting abusive tax shelters with little or no utility aside from the tax benefits that they generate.⁹² Broadly, in order for the penalty under § 6700 of the *IRC* to apply, a person must:

- organise, assist in the organisation, or participate in the sale of a tax shelter (ie. an entity, plan or arrangement), and
- in connection therewith, make or supply a statement regarding the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the tax shelter that the person knows or has reason to know:
 - (i) is false or fraudulent as to any material matter, or
 - (ii) is a gross valuation overstatement (exceeds 200 per cent of fair market value) as to any material matter.⁹³

A promoter may be an individual, a corporation, a partnership, a trust, or an estate, and although § 6700 of the *IRC* targets those marketing tax shelters; its coverage is much broader.⁹⁴ It

⁸⁹ *Income Tax Act* s 163.2(2).

⁹⁰ *Ibid* 1219.

⁹¹ *Ibid*.

⁹² S D Pollack and J A Soled, ‘Tax Professions Behaving Badly’ (October 2004) *Tax Notes* 201, 207.

⁹³ IRC § 6700 (1986).

⁹⁴ Tax Management Inc, ‘VIII Promoter and Protester Penalties’ *BNA Tax Management Portfolios*, US Income Series Procedure and Administration 634–2nd: Civil Tax Penalties, 2005 Tax Management, Inc., see <http://www.bna.com/tm/>.

appears that the penalty is more like the Canadian penalty than the New Zealand penalty in that there must be a fraudulent element in order for the penalty to apply.⁹⁵

Unlike Australia, New Zealand and Canada, the *IRC* does not contain a statutory GAAR. Unsurprisingly then, the penalty is not linked to a shortfall amount, as is the case with the New Zealand promoter penalties. Rather, the penalty under § 6700 is the greater of 100 per cent of the gross income derived from the activity and US\$1000.

2 Injunctions against Promoters

Section 7408(a) of the *IRC* allows the Internal Revenue Service ('IRS') to commence a civil action in the name of the US to enjoin any person from further engaging in conduct subject to a penalty under § 6700 of the *IRC*. However, injunctive relief prohibiting a person from acting will only be provided where the person has engaged in conduct subject to a penalty under § 6700; and, injunctive relief is appropriate to prevent recurrence of such conduct.

Accordingly, the IRS may seek an injunction to prevent the further promotion of abusive tax shelters by promoters. This is a different approach to the Australian promoter penalties legislation, where an injunction may also be sought against a promoter prior to a finding that there has been any promotion of a tax exploitation scheme.

3 Requirement for Promoters to Register Tax Shelters

Legislation requiring promoters of tax shelters to register with the IRS and to maintain lists of tax shelter investors have existed in some form in the US since 1984. For transactions occurring after 22 October 2004, new provisions of the *IRC* require 'material advisors' to file an information return with the IRS in respect of any 'reportable transaction'.⁹⁶ Broadly, a 'material advisor' is a person providing material aid, assistance or advice with respect to organising, promoting, selling, implementing or carrying out any reportable transaction, and who derives gross income in excess of US\$250 000 (US\$50 000 for services provided to natural persons) for such advice or assistance. 'Reportable transactions' are prescribed in the regulations to the *IRC*, and include the following: listed transactions; confidential transactions; transactions with contractual protection; loss transactions; transactions with a significant book-tax difference; and transactions involving a brief asset holding period. Failure to disclose a reportable transaction may result in a penalty of US\$100 000 (or for listed transactions, the greater of US\$200 000 or 50 per cent of the gross income derived by the person required to file the return).⁹⁷

Penalties of up to US\$100 000 may apply to 'material advisors' who fail to provide lists of investors in reportable transactions to the IRS within 20 business days of a request by the IRS.⁹⁸ Further, the *American Jobs Creation Act 2004* allows the IRS to seek injunctions against material advisors who fail to furnish investor lists to the IRS where requested, or who fail to file required information returns.⁹⁹

⁹⁵ Note also that § 6701 of the *IRC* imposes a penalty on those that knowingly and intentionally assist taxpayers in the understatement of their taxes.

⁹⁶ CCH, 'American Jobs Creation Act of 2004' (11 October 2004) *CCH Tax Briefing – Special Report*.

⁹⁷ CCH, 'American Jobs Creation Act of 2004' (11 October 2004) *CCH Tax Briefing – Special Report*.

⁹⁸ *IRC* §§ 6112, 6708.

⁹⁹ C A Symonds, J A B Boston and G Sincoff, *Law Firms and the American Jobs Creation Act of 2004* (2004) PricewaterhouseCoopers.

4 Circular 230

As in Australia, US tax professionals are subject to standards of practice applicable to lawyers, certified public accountants and tax practitioners. However, in addition to professional standards, Circular 230 governs the practice of lawyers, accountants, actuaries, enrolled agents and other persons practising before the IRS.

Circular 230 imposes requirements on tax advisers giving ‘covered opinions’. Relevantly, Circular 230 provides that any written opinion will be treated as a ‘covered opinion’ if it has a significant tax avoidance purpose.¹⁰⁰ A covered opinion must meet the requirements prescribed by Circular 230, otherwise the taxpayer cannot rely on the advice to avoid penalties. Further, tax advisers who wilfully, recklessly, or through gross incompetence violate Circular 230 are subject to sanctions.¹⁰¹

US tax advisers have been widely critical of the burdens imposed upon them by Circular 230, considering that the requirements will affect all practices and not just practices promoting tax shelters. This is because Circular 230 requires advisers to evaluate every piece of written tax advice to determine whether it is a ‘covered opinion’, which itself is a subjective process.¹⁰² If it is concluded that the advice is a ‘covered opinion’, there are five possibilities which the adviser must work through for the advice¹⁰³:

- the tax adviser is prohibited from giving the advice;
- the adviser may give the advice without a legend;
- the adviser may give the advice if it ‘prominently displays’ the non-marketing legend;
- the adviser may give the advice if it displays the non-marketing legend; and
- the taxpayer receiving the advice may or may not be able to rely on the advice for penalty protection.

In addition to being considered to impose too restrictive regulations on tax practice, Circular 230 may have detrimental results for tax avoidance. For example, Circular 230 may encourage advisers to provide non-written advice to taxpayers in order to fall outside of the scope of the standards.¹⁰⁴ This may mean that taxpayers enter into tax shelters without the benefit of reflecting upon a written advice which considers the aspects of the transaction in detail.

D UK

Disclosure legislation for direct taxation was introduced in the UK with effect from 30 September 2004.¹⁰⁵ The legislation requires promoters of arrangements to disclose details of arrangements to the UK Inland Revenue. The definition of ‘promoter’ is broad, encompassing all advice and proposals given to clients, rather than being restricted to mass-marketed schemes.¹⁰⁶ Currently, the promoter is required to make a disclosure to the Inland Revenue where one of the main benefits of the arrangement is the obtaining of a tax advantage by the saving or deferring of UK corporation tax, income tax or capital gains tax, in connection with a financial product or an employment product.¹⁰⁷ However, in the 2005 Pre-Budget Report, the Chancellor announced that

¹⁰⁰ D W Holbrook, ‘Imagine the Worst the US Treasury Could Do to Us – They’ve Done It. Revenge of the IRS: Circular 230 Changes Law Practice’ (August 2005) *Tennessee Bar Journal* 28, 29.

¹⁰¹ Circular 230, s 10.52.

¹⁰² M Schler, ‘Effects of Anti-Tax Shelter Rules on Nonshelter Tax Practice’ (November 2005) *Tax Notes* 915, 919.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Finance Act 2004* (UK) ss 306–19.

¹⁰⁶ C Dewar, ‘Final UK Tax Avoidance Disclosure Rules for Direct Tax’ (November 2004) 15 *Journal of International Taxation* 14.

¹⁰⁷ *Ibid.*

the regime would be extended to cover avoidance risks across all of income tax, corporations tax and capital gains tax, with effect from April 2006.

From October 2004 to 30 June 2005 there were 524 direct tax disclosures from 100 promoters.¹⁰⁸ Legislation has already been introduced to counter disclosed schemes, and the 2005 Pre-Budget Report contains further anti-avoidance measures informed by the disclosure regime.¹⁰⁹ Further, the Report also announced a new requirement for businesses to provide to HM Revenue and Customs, within 30 days of implementation, information on direct tax schemes and arrangements devised in-house so to bring requirements in line with those imposed on promoters.¹¹⁰

Disclosure provisions also exist in respect of indirect tax, such as Value Added Tax. However, unlike direct tax disclosures, the obligation to disclose indirect tax arrangements is generally an obligation of the taxpayer rather than the promoter.¹¹¹

E Conclusions

The new Australian civil penalty regime applying to promoters of tax exploitation schemes most closely resembles the recently enacted New Zealand regime. The New Zealand experience suggests that legislative definitions are crucial for the overall effectiveness of the legislation. This is particularly so, given that the New Zealand Inland Revenue consider that promoters continued to market schemes following the commencement of the legislation; only now to fewer customers at a time to circumvent the definition of the scheme to which the penalties apply.

The US, Canada and the UK have instead adopted disclosure regimes, requiring tax advisers and taxpayers to make prescribed disclosures to the revenue authorities. Again, the definitions used in the disclosure legislation may be expected to have had consequences for tax adviser and taxpayer behaviour. For example, the breadth of application of the disclosure regime may encourage taxpayers to evade tax rather than to seek planning advice from an adviser, in circumstances where the adviser may be required to make disclosures to the revenue authority.

V ASSESSMENT OF THE NEW LAW AS A MEANS OF OVERCOMING PROBLEMS WITH THE OLD LAW

A comparison of the new civil penalty regime with the approach of other jurisdictions to promoters demonstrates, first, that a disclosure model was an alternative to Division 290 of sch 1 of the TAA, and secondly, that there are lessons from other jurisdictions for Division 290. Further, an examination of the effect of the promoter penalty provisions compared to its purpose finds that there were some improvements which could be made to the provisions, to assist them in reaching the aim of reforming old tax laws for a new world.

First, the US, Canada and the UK have each adopted legislation requiring promoters of tax schemes to register the schemes with the relevant revenue authority before selling the scheme. Such legislation also requires the promoter to maintain lists of investors in the scheme, and in Canada, the promoter is required to file an annual information return including information about investors in the promoter's scheme. The Explanatory Memorandum to the recently enacted Australian legislation noted that it would be possible to supplement the civil penalty regime with

¹⁰⁸ KPMG, *Pre-Budget Report Predictions in Brief* <http://www.kpmg.co.uk/services/t/b/pbr_brief.cfm>.

¹⁰⁹ S Hughes, *Protecting Tax Revenues* (2005) Shout 99
<www.shout99.com/contractors/showarticle.pl?n=&id=36211&p=1>.

¹¹⁰ *Ibid.*

¹¹¹ R Fraser, 'Tax Scheme Disclosure Provisions' (2004) 4 *British Tax Review* 282, 288.

additional record-keeping and reporting requirements.¹¹² However, such requirements were considered to involve unduly high compliance costs, and there were also privacy concerns over the information collected and held by promoters.¹¹³

While the purpose of the disclosure regimes in the US, Canada and the UK is to provide the revenue authorities with information about tax schemes, the promoters and the investors, the effect of a disclosure regime may be to deter taxpayers from investing in schemes where the investment will need to be reported to the revenue authority.¹¹⁴ The Australian tax system is a self-assessment regime supported by administrative audit powers and penalties. Investors may reasonably consider that there is a greater risk of audit by the administration where a promoter is required to disclose the investors name and scheme to the revenue authority, than there is of being found to have evaded tax. A disclosure regime in Australia may in fact encourage taxpayers to evade tax as a less risky alternative to investing in a reportable tax scheme.

Secondly, some useful lessons emerge from New Zealand for Division 290. In New Zealand, the promoter has equivalent objection rights to penalties as those of taxpayers investing in tax schemes. However, in Australia, it is unclear whether promoters will have rights to appear before the GAAR Panel similar to those of taxpayers, in circumstances where there appears to be no policy reason for distinguishing between the two. On the other hand, the New Zealand legislation may demonstrate some benefits following from the recently enacted Australian definition of 'promoter'. While the Australian definition of 'promoter' has been criticised as being too broad and failing to exempt tax advisors, the New Zealand definition may be too narrow by merely targeting promoters of mass-marketed schemes (that is, schemes offered, sold, issued or promoted to 10 or more persons in a tax year).

It is also considered that the New Zealand legislation may benefit from the flexibility of the voluntary undertakings adopted in the Australian legislation, particularly if voluntary undertakings are required to be published. However, an examination of the effect of the promoter penalty provisions compared to the purpose leads to the conclusion that the legislation lacks a taxpayer education function. It would have been beneficial for the civil penalty regime to have provided publicity orders as a fourth power available to the Commissioner for deterring the promotion of tax exploitation schemes. It is also suggested that the civil penalties could be improved by allowing the Court a discretion to require a delegate of the Commissioner to meet with the promoter on a periodic basis, for a review of its schemes and its client education policies, to prevent a situation where the monetary penalty is insufficient to deter the promotion of tax exploitation schemes.

¹¹² Explanatory Memorandum, [3.124]. The Explanatory Memorandum states that this would include 'requiring promoters to report certain tax effective schemes to the Commissioner and to keep additional records in relation to financing arrangements and investor details'.

¹¹³ Ibid. The Explanatory Memorandum further provides, at [3.148]: 'The civil penalty regime is preferred to the options of administrative penalties and increased reporting/disclosure requirements because it is a more targeted and transparent measure that provides for substantial remedies to be imposed by the Federal Court against illegitimate promoters, while imposing low or no compliance costs on legitimate businesses'.

¹¹⁴ Fraser, above n 111, 290.

RESEARCHING TAX USING TECHNOLOGY: A SURVEY OF STUDENT ATTITUDES

JENNIFER BUTLER*

Technology and the Internet play an ever-increasing role in tax research and the current practice of tax. Hard-copy resources are becoming less common and increasingly information is being provided in electronic form or available on the Internet. This change has important ramifications for the way tax research is conducted. A primary source of information in the tax arena is the Australian Taxation Office website. This site contains a vast amount of information, which by necessity makes navigation of the site complex. However, this is an important resource which is freely available to the public so the importance of learning to navigate this resource so as to fully utilise the information available cannot be understated. This paper explores the attitudes of tax students towards the Internet generally, and the Australian Taxation Office website specifically, to determine whether students need further assistance in accepting the use of technology as the medium for tax research.

I INTRODUCTION

The study of tax has rapidly progressed from being based in textbooks and hard-copy loose leaf services to an activity that is more usually conducted in front of a computer. We are moving away from the 'olden days' where research was conducted cross-legged in the aisles of the library, flipping through a loose-leaf service prior to hours at a photocopier copying the material that was considered important. Today, a student is more likely to be slouched at a computer for hours in pursuit of the information required to conduct research, particularly of the doctrinal kind. Information that was once found in massive leather-bound volumes is now contained, in large part, in massive computer databases. This change in technology and information sourcing is of no less importance to practitioners than accounting students. Students studying taxation law have an inordinate amount of information and technology at their disposal. However, this volume of information does not necessarily make the study of taxation law a simple task.

In an effort to make taxation laws more accessible, the Australian Taxation Office ('ATO') has put all legislation and a raft of additional interpretative material on their website, free of charge. While this makes the material readily available for public use, the site is necessarily complex and can be difficult to use. Students therefore need to be able to readily access the site to enhance their research capabilities. To assist students in gaining these skills, a CD-ROM has been developed entitled 'Navigating the ATO'. In an effort to determine how the users of this technology accept and use this technology a study was conducted of third year accounting students studying taxation law. The study finds that while students accept the use of the Internet there is still some work to be done to make the ATO websites more user-friendly.

II BACKGROUND TO THE PROJECT

This project involves students studying taxation law at Central Queensland University ('CQU'). The majority of these students (95 per cent) are completing a degree in accounting and are generally in the final stages of their degree. Anecdotally, a large proportion of these students

* B. Com, LLB (Qld); Lecturer, Central Queensland University Faculty of Business and Law.

will go on to become accountants and tax agents while others will work in areas of accounting where tax is more of a peripheral issue. Many of these students are already working in accounting firms while completing their degrees. The students came from a variety of different backgrounds and also differed in terms of existing proficiency levels both in the area of tax and in the area of computer literacy.

Upon entering the workforce it is expected that these students will be able to make an immediate contribution in the area in which they work. The intention of the project is to enhance the students' generic abilities in information literacy and also to develop specific tax research skills. Both of these skills are becoming increasingly important considering the increasing reliance on technology. Technology-literate students have an advantage in that they are better equipped to deal with the demands of researching tax in an environment that is almost completely electronic. Admittedly, information literacy also entails another component which relates to what a person does with the information once they have obtained it. This project does not deal with that component of information literacy.

One might wonder why specific skills in tax research are required when information literacy is a widely taught generic skill and one that is generally covered in some depth in a business/accounting course. Are these skills not transferable so to allow students to engage in computer-based tax research? Are legal research skills also insufficient to allow a student studying tax to engage in tax research without requiring additional skills? While one might argue that the skills taught in other areas are indeed sufficient to allow for successful tax research, it might also be recognised that subject-specific tax resources are different to resources available in other accounting areas and even other areas of law.

Taxation law is contained in legislation and interpreted in cases, as is other law, but there are a whole range of additional extrinsic materials that may affect interpretation of this law. These materials include Public and Private Rulings, Practice Statements, Taxpayer Alerts, Interpretative Decisions and other publications produced by the ATO to disseminate information. Rulings, in particular, have acquired something akin to legal status in that they are binding on the Commissioner where the outcome is favourable to the taxpayer,¹ although it is arguable whether or not this should be the case.² It is therefore vital that those engaging in the practice of tax, and those intending to do so, are able to access these materials if they are to utilise them effectively in their research. It is also vital that we gain some understanding into the factors that affect the use of technology by those engaging in tax research.

Commercially, these materials are contained in databases available from publishing companies such as CCH. There are also other databases that are available without cost which contain some or all of these sources of taxation law. Legislation is available from the Australian Government Attorney-General's Department COMLAW site.³ The Australasian Legal Information Institute ('AustLII') site⁴ contains case law from most jurisdictions in Australia and New Zealand in addition to legislation. However, a major source of information in taxation law, and the one which is utilised in this project, is the ATO website. The ATO have their information divided into two sites. One of these is a legal database⁵ which contains legislation, cases, rulings and a

¹ *Income Tax Assessment Act 1936* (Cth) s 170BA(3).

² See *Bellinz Pty Ltd v FCT* (1998) 98 ATC 4399, 4417.

³ Commonwealth Government, Attorney-General's Department, ComLaw (federal law incorporating the Federal Register of Legislative Instruments) <<http://www.comlaw.gov.au/comlaw/comlaw.nsf/homepage?OpenForm&Expand=1.1>>.

⁴ Australasian Legal Information Institute <<http://www.austlii.edu.au/>>.

⁵ Australian Taxation Office, ATOLaw <<http://law.ato.gov.au/atolaw/index.htm>>.

range of other extrinsic materials that guide interpretation of the tax law. The other site⁶ contains media releases, fact sheets and numerous other sources of information which disseminates tax information to the public to encourage increased compliance, rather than disseminating the laws themselves.

While the author was teaching third year taxation law students, it became apparent that the students lacked knowledge about the specialist tax resources available to them. It also seemed that the students lacked the necessary knowledge and skills to enable them to access and use this information. Observation of their work indicated that they were not using the resources available despite the fact that there were references to these resources in course materials. Special classes were started dealing with information literacy and tax-specific materials but the use of these materials in assessment items still did not reach a noticeable level. Even when ATO sites were discussed in class and information was given as to the location of the sites, it was rare to see information from the sites used in answers to assessment. It is difficult to measure uptake of such resources; the only real measure available was to look for changes in references to such materials in assessment items and this was not occurring.

In an attempt to fill the gaps that seemed to exist in the knowledge that students had about available resources, a CD-ROM was developed in collaboration with CQU's Multimedia Design Centre. The CD-ROM is entitled 'Navigating the ATO' and contains a tutorial that guides students around the ATO websites. The tutorial also allows students to work on the Internet while the tutorial is running to conduct the searches concurrently. This allows students to learn by doing, which in most cases will allow students to learn the skills taught in the tutorial in the shortest amount of time. The design of the CD-ROM is meant to give students an idea of the variety of materials that they can find on the ATO sites. This is done by looking at some different examples of material to illustrate to students that there are a number of types of information available. The types of materials to which the tutorial guides students are general information pages, publications, forms and areas within the general ATO website. The areas within the ATO Legal Database to which the students are introduced are legislation, rulings, updates, and case judgements. The intention is that students will then be aware of the range of different materials available on the sites.

To make the information in the CD-ROM relevant to the students, the examples are carefully chosen to relate to topics the students are studying. This is to ensure that the information used in the examples covers areas that students are often personally interested in at the time that they complete the tutorial. For example, the topic 'working while studying' is used to illustrate the general principles of searching via the left-hand frame on the home page of the ATO site. Another example of this is the use of Taxation Ruling TR 98/17, which looks at residency for tax purposes in Australia, as the ruling illustrating how to find a taxation ruling. This topic is of interest to students in the early stages of a taxation law course as it is one of the first topics covered in the course. The use of topics that are either personally relevant or directly relevant to the material in the course serves to spark student interest in the material being covered, as they can immediately see how this information can be useful to them. This should then have the effect of encouraging use of the site both in their studies and in the workforce as it reinforces the value of being able to find such information.

In a further effort to give information literacy in this context some immediate value, a short online quiz has been designed. The quiz is worth 10 per cent of the total marks for the course. This quiz requires students to navigate to various areas of the ATO sites to find the answers to

⁶ Australian Taxation Office, <<http://www.ato.gov.au>>.

the questions posed. The questions relate to documents contained on the ATO sites. Prior to the introduction of the quiz, the CD-ROM was available without a summative (or additive) assessment component attached. Anecdotal evidence showed a minor increase in references to the ATO sites in assessment items during this time. However, it was thought that students were more likely to attach greater value to the skills being taught if some form of summative assessment was required.

The strong push towards technology in tax research and the consequent encouragement of students to take up this technology assumes that these students have the skills and ability to use the technology. This may not always be true. While it may be a fair assumption for those who have come straight from school and have attained high levels of computer literacy through learning in school, it may not be a fair assumption for other students in the course. There are a large per centage of university students who did not commence tertiary study until some years after completing school. For these students, computer literacy is likely to be lower. There are also many students who come into university with an overseas educational background. The computer skills of those students may depend on the courses previously studied and the country in which they studied. It is important to determine whether the students utilising technology to obtain tax information have the skills and abilities to do so. If not, it may turn out that we are setting these students an impossible task.

While we are giving the students in this course an opportunity to become familiar with the premier source of tax information, it may be that there are other factors which affect whether or not these students choose to use this information. Even when given the opportunity to use the ATO sites, students may still choose not to do so. Some of the factors that may affect whether students use the ATO sites could be the perceived usefulness of the sites, perceived ease of use of the sites, availability of support, social pressure, through to personal traits such as innovativeness, gender, prior experience or educational level.

This study considers the factors that may affect the use of the ATO sites on two levels. First, it looks at perceived usefulness and perceived ease of use of the Internet. Consideration is also given to whether innovativeness impacts on these factors. Second, the study goes on to consider whether perceived usefulness and perceived ease of use of the Internet are related to perceived usefulness and perceived ease of use of the ATO websites. It is important that these factors are considered in light of the special requirements that tax students have for information and the fact that this information is largely available via technology.

III FACTORS AFFECTING THE ADOPTION AND USAGE OF NEW TECHNOLOGY

The variables that were tested are based on the Technology Acceptance Model ('TAM')⁷ as developed by Fred Davis, and the concept of innate innovativeness. Since its development, there has been much written that helps to explain why individuals will more readily accept some technological applications over others.⁸ The TAM is used to predict and explain the acceptance

⁷ Fred Davis, 'Perceived Usefulness, Perceived Ease of Use, and User Acceptance of Information Technology' (1989) 13 *MIS Quarterly* 319.

⁸ See, eg, Waiman Cheung and Wayne Huang, 'Proposing a framework to assess Internet usage in university education: an empirical investigation from a student's perspective' (2005) 36 *British Journal of Educational Technology* 237; Min Gong, Yan Xu and Yuecheng Yu, 'An Enhanced Technology Acceptance Model for Web-Based Learning' (2004) 15 *Journal of Information Systems Education* 365; William Lewis, Ritu Agarwal and v. Sambamurthy, 'Sources of influence on beliefs about information technology use: An empirical study of knowledge workers' (2003) 27 *MIS Quarterly* 657; Dennis A Adams, R Ryan Nelson and Peter A Todd, 'Perceived Usefulness, Ease of Use and Usage of Information Technology: A Replication' (1992) 16 *MIS Quarterly* 227.

of information technology using perceived usefulness and perceived ease of use as determinants of behaviour. Similar variables were used in Davis' original study.⁹

Perceived usefulness is defined as 'the degree to which a person believes that using a particular system would enhance his or her job performance'.¹⁰ Perceived ease of use is defined as 'the degree to which a person believes that using a particular system would be free of effort'.¹¹ These concepts derive from work in management information systems, human-computer interaction and marketing.¹² Specific theories utilised in developing the model were expectancy theory, self-efficacy theory, behavioural decision theory and diffusion of innovations theory. It is from these areas that Davis drew his assertion that perceived ease of use and perceived usefulness were salient factors in measuring the acceptance of technology.

Both the factors of 'perceived usefulness' and 'perceived ease of use' have been found to be significantly correlated with self-reported indicators of system usage.¹³ However, perceived usefulness shows the strongest correlation with usage.¹⁴ This makes sense in that while 'difficulty of use can discourage early adoption of an otherwise useful system, no amount of ease of use can compensate for a system that does not perform a useful function'.¹⁵ The accuracy of these variables as determinants of system usage has been described in numerous further studies that have specifically targeted technology use in management education,¹⁶ in universities,¹⁷ in a gender studies context¹⁸ and in numerous other applications.¹⁹

Further, ease of learning has been found to be related to ease of use²⁰ to the extent that the two factors can be considered congruent.²¹ Consequently, in the TAM, ease of learning is not treated as a separate factor, but is treated as part of the determinant of ease of use.²² This study follows the TAM on this point.

Perceived usefulness is described as an extrinsic motivator while perceived ease of use is described as an intrinsic motivator. These motivators are also affected by a number of external factors which are not considered in the TAM although it is suggested that they would be of benefit.²³ Their use as motivating factors has been shown in a study by Cheung and Huang where they were used to promote Internet use in university study.²⁴

⁹ Davis, above n 7, 323.

¹⁰ Ibid 320.

¹¹ Ibid.

¹² See A Bandura, 'Self-Efficacy Mechanism in Human Agency' (1982) 37 *American Psychologist* 122; R L Schultz and D P Slevin, 'Implementation and Organizational Validity: An Empirical Investigation' in R L Schultz and D P Slevin (eds), *Implementing Operation Research/Management Science* (1975); D Robey, 'User Attitudes and Management Information System Use' (1979) 22 *Academy of Management Journal* 527.

¹³ Davis, above n 7, 332.

¹⁴ Ibid 333.

¹⁵ Ibid 334.

¹⁶ Judy Drennan, Jessica Kennedy, and Anne Pisarski, 'Factors Affecting Student Attitudes toward Flexible Online Learning in Management Education' (2005) 98 *The Journal of Educational Research* 331.

¹⁷ Cheung and Huang, above n 8.

¹⁸ David Gefen and Detmar Straub, 'Gender Differences in the Perception and Use of E-Mail: An Extension to the Technology Acceptance Model' (1997) 21 *MIS Quarterly* 389; Viswanath Venkatesh and Michael G. Morris, 'Why Don't Men Ever Stop to Ask for Directions? Gender, Social Influence, and Their Role in Technology Acceptance and Usage Behaviour' (2000) 24 *MIS Quarterly* 115.

¹⁹ Adams, Nelson and Todd, above n 8; Xiaodong Deng et al, 'A Multi-Group Analysis of Structural Invariance: An Illustration Using the Technology Acceptance Model' (2005) 42 *Information and Management* 745; Leroy Robinson Jr., Greg Marshall, Miriam Stamps, 'An Empirical Investigation of Technology Acceptance in a Field Sales Force Setting' (2005) 34 *Industrial Marketing Management* 407.

²⁰ T L Roberts and T P Moran, 'The Evaluation of Text Editors: Methodology and Empirical Results' (1983) 26 *Communications of the ACM* 265.

²¹ J Whiteside et al, 'User Performance with Command, Menu, and Iconic Interfaces' (Paper presented at the CHI Conference, San Francisco, 14-18 April 1985).

²² Davis, above n 7, 325.

²³ M Igarria, S Parasuraman and J J Baroudi, 'A Motivational Model of Microcomputer Usage' (1996) 13 *Journal of Management Information Systems* 127.

²⁴ Cheung and Huang, above n 8.

Innovativeness is also of predictive use in studies of the uptake of technology.²⁵ Innovative attitude has been shown to be related to computer use²⁶ generally and to early adoption of innovations in information technology.²⁷ Innovative attitude also has a positive effect on the determinant of perceived usefulness in the TAM.²⁸ The concept of innovativeness refers to the willingness of an individual to try something new. It has been suggested by Agarwal and Day that in the context of innovation in information technology this would mean that innovation refers to an individual's propensity to have positive beliefs about technology and its use.²⁹ In this study we are looking at the willingness of the student to use the Internet generally and the ATO websites specifically.

Cheung and Huang³⁰ gave consideration to the motivator of social pressure, which was also found to positively relate to Internet usage. Their study also looked at the IT Diffusion Process Model,³¹ considering the impact of Internet usage as an additional set of variables. This step is of interest to us in our context because it considers the impact of the Internet on learning and on job prospects. Of specific interest is the finding that students perceive that Internet usage provides them with better job prospects.³² They also perceive that Internet usage assists their learning in the areas of general learning, distance learning and constructive learning. The study suggests that:

Internet use may help students heighten their constructive learning by enhancing their constructive learning motive and strategy. Constructive learning motive and strategy refers to forms of learning behaviour such as 'while I am studying, I often think of real life situations where the material I am learning would be useful', which are generally considered to indicate a higher level of learning. Hence, constructive learning can help universities and instructors to bridge the gap between university education and the needs of business organisations. This gap has become a key issue in university education because universities have sometimes been criticised for failing to meet the requirements and needs of the business world.³³

While it is outside the scope of the current study to consider these additions to the TAM, they are factors that are worthy of consideration in future research.

IV HYPOTHESES

Using the constructs provided by the TAM, in order to determine whether students use or intend to use the ATO websites, we first need to determine their attitudes towards the Internet generally. If students do not use the Internet then it is unlikely that they will choose to use sites located on the Internet. As innovativeness has been positively linked to usage of technology,³⁴ we examine the views of those with high innovativeness in regard to perceived usefulness and perceived ease of use of the Internet. The second stage of the study examines whether perceived usefulness and ease of use of the Internet have a positive relationship with perceived usefulness and ease of use of the ATO site. The third stage of the study examines whether the perceptions of

²⁵ Judy Drennan and Jessica Kennedy, 'Small Firm Internet Uptake: How Important Is an Innovative Attitude?' (Paper presented at the Conference Proceedings of ANZMAC 2000, Gold Coast, 6-9 December 2000); G Foxall and S Bhate, 'Computer Use Innovativeness: Cognition and Context' (1999) 17 *International Journal of Technology Management* 157.

²⁶ Foxall and Bhate, above n 25.

²⁷ Ritu Agarwal and A E Day, 'The Impact of the Internet on Economic Education' (1998) 29 *Journal of Economic Education* 99.

²⁸ Drennan, Kennedy and Pisarski, above n 16.

²⁹ Agarwal and Day, above n 27, 101.

³⁰ *Ibid.*

³¹ Detmar Straub, 'The Effect of Culture on IT Diffusion: E-mail and Fax in Japan and the US' (1994) 5 *Information Systems Research* 23.

³² Cheung and Huang, above n 8, 247.

³³ *Ibid.*

³⁴ Drennan, Kennedy and Pisarski, above n 16.

ease of use and perceived usefulness of the ATO site have changed from the beginning of the term to the end of the term. The final stage of the study examines whether perceived usefulness and ease of use of the ATO site at the end of the term are predictive of the outcome.

Therefore, the hypotheses that are proposed in relation to this study are as follows:

- H1: Innovativeness will be positively related to perceived usefulness of the Internet.
- H2: Innovativeness will be positively related to perceived ease of use of the Internet.
- H3: Perceived ease of use of the Internet will be positively related to perceived ease of use of the ATO.
- H4: Perceived usefulness of the Internet will be positively related to perceived usefulness of the ATO.
- H5: Perceived usefulness of the ATO and will be positively related to perceived ease of use of the ATO.
- H6: Perceived ease of use of the ATO rises significantly between the beginning and end of the term.
- H7: Perceived usefulness of the ATO rises significantly between the beginning and end of the term.
- H8: Perceived ease of use of the ATO at the end of the term and perceived usefulness of the ATO at the end of the term are predictive of the usefulness of the CD-ROM.

V METHOD

A Survey Instrument

The survey instrument was administered in week two of the term and again in week nine of the term. The first survey was administered after the students had received the CD-ROM but prior to use of the ATO sites for study purposes. In the first survey there was a filter question to ensure that only those students who had already used the ATO websites went on to answer the questions in relation to the site. In the second survey it is assumed that students had reached some level of familiarity with the ATO websites. The first survey is designed to measure perceived usefulness and perceived ease of use of the Internet and the innate innovativeness of the respondents. Further factors that the survey is designed to measure are the perceived usefulness and perceived ease of use of the ATO websites. It also collects information on various personal and situational variables that may influence perceptions such as use of the Internet, Internet enjoyment and Internet access. The second survey was administered after the students had used the CD-ROM, 'Navigating the ATO', and completed the related online quiz. The second survey looks at perceived ease of use and perceived usefulness of the ATO websites to ascertain whether there is any difference in the perceptions of the students at the two points in time. The second survey also looks at the students' attitudes towards the online assessment and whether the CD-ROM was of assistance in completing the online assessment.

B Participants

Participants in the study were students in a third year university course in taxation. There were 594 students enrolled in the course, however, they were not all present at the lectures in which the survey was conducted. Of these, 148 students responded to the survey, giving a response rate of 25 per cent of the total student enrolment in the course. There were 51 male respondents (35 per cent) and 96 female respondents (65 per cent). One student did not nominate gender. The second survey had a response of 102 students (17 per cent). 40 respondents (39 per cent) were

male and 61 respondents (60 per cent) were female with one respondent (1 per cent) not nominating gender.

C Procedure

Lecturers asked all students present at lectures in weeks two and nine to self-complete the survey questionnaires. The questionnaires were accompanied by a consent form and information sheet and respondents were assured that their results would remain confidential and that participation was entirely voluntary. Students studying by flexible mode received the survey questionnaires in the mail. Students were given 15 minutes to complete the survey. Responses were returned to the lecturer at that time, although any student who chose to complete the survey at home and return it later was given the option to do so.

VI MEASURES

All of the variables below except hours of Internet use were measured using five-point Likert scales.

- *Innate Innovativeness*: was measured using 11 items derived from the Ettlíe and O'Keefe³⁵ 20-item Innovative Attitude Scale. Reliability analysis indicated a Cronbach's alpha of 0.85 on the 11 items.
- *Perceived Ease of Use of the Internet*: there were six ease of use items derived from the original six-item scale of Davis.³⁶ These items include statements relating to ease of learning to use the Internet as ease of learning is considered to be a substratum of ease of use rather than a separate construct.³⁷ These items showed a Cronbach's alpha of 0.71 when tested for reliability.
- *Perceived Usefulness of the Internet*: These six items were designed specifically for this questionnaire to determine the perceived usefulness of the Internet for study, work and research. Reliability analysis performed on these items indicated a Cronbach's alpha of 0.68.
- *Perceived Ease of Use of the ATO Sites*: Four original items were used to determine students' attitudes regarding how easy the ATO websites are to use. These items showed a Cronbach's alpha of 0.815.
- *Perceived Usefulness of the ATO Sites*: To determine student's attitudes towards the usefulness of the ATO websites there were four items loosely based on the six-item scale by Davis.³⁸ The Cronbach's alpha of these items was 0.925.

A number of questions were asked to obtain background information. The first of these is a standard question to determine how many hours the participants use the Internet. There were five response groups as indicated in Table 1. Two of the questions used a five-point Likert scale and were used to determine whether the respondent likes playing with the Internet and whether they find the Internet easy to navigate.

- *Hours of Internet Use*: Students were asked to nominate the range of hours that they used the Internet weekly.

³⁵ J Ettlíe and R D O'Keefe, 'Innovative Attitudes, Values, and Intentions in Organizations' (1982) 19 *Journal of Management Studies* 163.

³⁶ Davis, above n 7.

³⁷ *Ibid* 325.

³⁸ *Ibid*.

- *Internet Enjoyment*: Students were asked for the level of agreement with the statement ‘I enjoy playing around with the Internet’.
- *Ease of Navigation of the Internet*: Students were asked to respond to the statement: ‘I find it easy to navigate the Internet’, by indicating agreement on the scale from strongly agree to strongly disagree.

In addition, students were asked about their age, number of hours worked outside study, their source of Internet access and reliability of Internet access as background questions to get some insight into the situational variables that may affect the uptake of this technology.

In the second survey reliability analysis revealed the following:

- *Perceived Ease of Use of the ATO Sites at the End of the Term*: Four original items were used to determine student’s attitudes regarding how easy the ATO websites are to use. These items showed a Cronbach’s alpha of 0.691.
- *Perceived Usefulness at the End of the Term*: To determine student’s attitudes towards the usefulness of the ATO websites there were four items loosely based on the six-item scale by Davis.³⁹ The Cronbach’s alpha of these items was 0.862.
- *Usefulness of the CD-ROM*: Four questions on whether the CD-ROM ‘Navigating the ATO’ was useful in completing the online assessment task. The Cronbach’s alpha of these items was 0.713.

VII DATA ANALYSIS

Responses to the background questions in the first survey tell us that 86 per cent of the respondents in this study are aged between 18 and 30. Ninety five per cent of these are studying a Bachelor of Accounting degree at CQU. Half of the students (54 per cent) work less than 20 hours per week, while a significant number (29 per cent) do not have any paid employment. A small number of students reported working full-time (5 per cent) with 15 per cent reporting over 30 hours of work per week.

In relation to Internet access, most of the respondents have Internet access which they consider to be generally reliable (84 per cent). There is some concern from a teaching perspective, however, that a number of students expressed that they only have occasional access (7 per cent) or no access at all (1 per cent) to the Internet. This is especially worrying since third year accounting students rely heavily on computers to complete their studies, and because the course requires Internet use for assessment tasks. This result is not reflected in course performance however since students have the option to obtain alternative assessment where Internet access is not available. No students chose to avail themselves of this option.

The question about location of access yielded the result that a large majority (75 per cent) access the Internet at home or work rather than at University. Table 1 sets out this background information.

³⁹ Ibid.

Table 1: Background Information Relating to Employment and Internet Access

Background Information	
Location of Access	
At Home	72 per cent
At Work	3 per cent
At University	24 per cent
Other	1 per cent
Access to the Internet	
Generally Reliable	84 per cent
Minor Problems with Access	8 per cent
Can Occasionally get Access	7 per cent
No Access	1 per cent
Hours Worked Outside Study	
None	29 per cent
Less than 10 hours	7 per cent
11 – 20 hours	47 per cent
21 –30 hours	2 per cent
31 – 40 hours	10 per cent
More than 40 hours	5 per cent

Internet usage of less than 10 hours per week was reported by more than half (62 per cent) of respondents. A small percentage (16 per cent) reported high-level Internet usage of more than 21 hours per week. Interestingly, when these results were broken down by gender, the majority of female respondents reported Internet usage of less than 10 hours per week (71 per cent) while less than half (45 per cent) of male respondents reported that level of usage. High-level Internet usage of over 21 hours showed a corresponding difference with only 14 per cent of female students reporting this level of usage and 22 per cent of males. This difference in response contrasts with responses to the statement: ‘I like playing around with the Internet’, which has an almost identical response rate for both male and female respondents. The overall response rate to this question indicates that only 22 per cent of students do not like playing around on the Internet.

Table 2: Hours of Internet Use per Week

Hours Used Per Week	Male	Female	Total
Less than 5	14.3 per cent	32.3 per cent	26 per cent
6 – 10 hours	30.6 per cent	38.5 per cent	36 per cent
11 – 15 hours	22.4 per cent	11.5 per cent	15 per cent
16 – 20 hours	10.2 per cent	4.2 per cent	7 per cent
More than 20 hours	22.4 per cent	13.5 per cent	16 per cent

A Pearson correlation matrix was used to test the first two hypotheses. The Pearson correlation matrix for hypotheses H1 and H2 is shown at Table 3. The first hypothesis that innovativeness will be positively related to perceived usefulness of the Internet has been supported. Perceived usefulness has been shown to be a strong predictor of Internet use. This result would be expected

as results in prior studies have shown that there is a positive relationship between innovativeness and perceived usefulness.⁴⁰

The second hypothesis that innovativeness will be positively related to perceived ease of use of the Internet is also supported. This shows that those who consider themselves to be innovative in attitude also perceive that the Internet is easy to use.

Table 3: Pearson Correlation Matrix for Internet

Variable	Perceived Usefulness of Internet	Perceived Ease of Use of Internet	Innovativeness
Perceived Usefulness of Internet			
Perceived Ease of Use of Internet	.156		
Innovativeness	.494**	.367**	

*Correlation is significant at the 0.01 level (2 tailed)

** Correlation is significant at the 0.05 level (2 tailed)

The second stage of this study examines whether there is a relationship between perceptions of the Internet and perceptions of the ATO websites. This part of the study required a close analysis of responses from students who had actually used the ATO websites. There were 117 responses indicating prior use of the ATO websites.

The second stage of the study considers the hypotheses H3, H4 and H5. A Pearson correlation matrix is used to test the hypotheses. The Pearson correlation matrix for hypotheses H3 to H5 is shown at Table 4. Hypothesis H3 — that perceived ease of use of the Internet will be positively related to perceived ease of use of the ATO — is not supported. This is a surprising finding.

Table 4: Pearson Correlation Matrix for ATO

Variable	Perceived Usefulness ATO	Perceived Usefulness Internet	Perceived Ease of Use ATO	Perceived Ease of Use Internet
Perceived Usefulness ATO				
Perceived Usefulness Internet	.465**			
Perceived Ease of Use ATO	.312**	.181		
Perceived Ease of Use Internet	.334**	.178	.076	

Hypothesis H4 that perceived usefulness of the Internet will be positively related to perceived usefulness of the ATO has been supported. Those who find the Internet to be useful also find the ATO websites to be useful. Interestingly, while perceived ease of use of the Internet was not positively related to perceived ease of use of the ATO, it was positively related to perceived

⁴⁰ Drennan and Kennedy, above n 25.

usefulness of the ATO. Therefore, even though students did not find the ATO sites easy to use they still found the sites to be useful.

Hypothesis H5 states that perceived usefulness of the ATO and perceived ease of use of the ATO will be positively related. This hypothesis is supported. This finding is similar to earlier findings using TAM⁴¹ where these two factors have shown a significant positive relationship.

The third stage of the research tested whether there was a significant difference between student perceptions of perceived ease of use and perceived usefulness of the ATO websites, before and after completing the online assessment with the aid of the ‘Navigating the ATO’ CD-ROM. The results as shown in Table 5 indicate that the exercise has had minimal effect in changing student attitudes. There is a slight upwards shift in perception but this is insignificant.

Table 5: T-Tests for Perceived Ease of Use and Perceived Usefulness

Variable	N	Mean	Std. Dev.
Ease of Use of ATO survey 1	123	9.32	3.82
Ease of Use of ATO survey 2	98	10.3	3.37
Perceived Usefulness of ATO survey 1	126	14.87	4.52
Perceived Usefulness of ATO survey 2	99	15.47	3.22

The final stage of the study involves a multiple regression analysis to determine whether the usefulness of the CD-ROM could be predicted by the perceived ease of use and perceived usefulness of the ATO at the end of the term. The results of this analysis indicated that perceived ease of use of the ATO at the end of the term and perceived usefulness of the ATO at the end of the term accounted for a significant portion of the outcome variability: $R^2 = .16$; $F(2,89) = 9.82$; and $p < .01$.

This indicates that students who believed that the ATO was useful at the end of the term also scored highly on the usefulness of the CD-ROM variable. Similarly, students who believed that the ATO websites were easy to use scored highly on the usefulness of the CD-ROM variable at the end of the term. Students who scored highly on the usefulness of the CD-ROM variable believed that the CD-ROM ‘Navigating the ATO’ was useful in completing the online assessment task.

The results of this study in respect of each Hypothesis are summarised in Table 6.

⁴¹ Davis, above n 7.

Table 6: Summary of Results

Hypothesis	Statement of Relationship	Result
H1	Innovativeness will be positively related to the perceived usefulness of the Internet	Supported
H2	Innovativeness will be positively related to perceived ease of use of the Internet	Supported
H3	Perceived ease of use of the Internet will be positively related to perceived ease of use of the ATO	Not supported
H4	Perceived usefulness of the Internet will be positively related to perceived usefulness of the ATO	Supported
H5	Perceived usefulness of the ATO and perceived usefulness of the ATO will be positively related	Supported
H6	Perceived ease of use of the ATO at the beginning of the term is positively related to perceived ease of use of the ATO at the end of the term	Not supported
H7	Perceived usefulness of the ATO at the beginning of the term is positively related to perceived usefulness of the ATO at the end of the term	Not supported
H8	Perceived ease of use of the ATO at the end of the term and perceived usefulness of the ATO at the end of the term are predictive of the usefulness of the CD-ROM.	Supported

VIII DISCUSSION

This exploratory study has shown, first, that innovativeness is positively related to the factors that have been shown to determine Internet usage, perceived ease of use and perceived usefulness. This indicates that those students who believe that they are highly innovative individuals believe that the Internet is easy to use and that it is a useful tool to them. This is especially relevant for lecturers and teachers taking subjects requiring use of the Internet, who should recognise this link between a student's innovativeness, and their ability to make use of the Internet as a resource. Further, innovative attitudes are inherent to the individual and not easily changed, and it is natural that some students will be more difficult to convince regarding its benefits.

This study has also found that those who believe that the Internet is easy to use do not believe that the ATO websites are easy to use. This may be due to the implicit complexity of the ATO websites. The complexity of the sites is caused by the fact that they contain a large amount of information and this information is updated constantly. This leads to a number of different navigational paths to search for any one piece of information. While this complexity may be necessary given the amount of information contained on the sites, it seems that this makes the site more difficult to use. Research on technology generally has shown that as time passes ease of use has a less significant impact on usage because the technology becomes more familiar to users.⁴² Surprisingly, however, even after the students have used the CD-ROM 'Navigating the ATO' and have completed the online assessment testing their navigational skills, their perception that the ATO sites are difficult to use has not changed significantly.

⁴² Ibid.

The positive relationship between perceived usefulness of the Internet and perceived usefulness of the ATO shows that there would be some benefit in ensuring that students are familiar with the Internet prior to studying tax. This is so, particularly given that perceived ease of use of the Internet is also related positively to perceived usefulness of the ATO. If students are shown that the Internet is a useful tool for research in earlier subjects then they will be more likely to perceive that tax sites located on the Internet will also be useful. Further, if their learning is supervised, it will allow lecturers to explain the distinction between credible sources and non-credible sources of information. This has important consequences for those wishing to go into practice following study as they will be well on the way to developing a skill readily transferable to an accounting workplace.

This study shows that students who are innovative find the Internet useful and they find it easy to use. These students recognised the benefits of the ATO websites, although the sites were not considered user-friendly even after they had been given training. The ATO sites are the primary source of freely available tax information. It is therefore imperative that students are given assistance in using these sites so that these valuable sources of tax information can be effectively utilised both for study and for work.