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FOREWORD

The papers included in this edition of the *Journal of the Australasian Tax Teachers Association (JATTA)* are based on presentations made at the 19th Annual Conference of the Australasian Tax Teachers Association (ATTA) held on 24th to 26th January 2007 at The University of Queensland, Brisbane.

Professor Charles Rickett, Head, TC Beirne School of Law, The University of Queensland opened the conference and welcomed delegates. On the first day the plenary presentation was given by Mr Michael D'Ascenzo, Commissioner of Taxation who presented his paper entitled '*Simplifying Tax Administration in a Complex World*'. On the second day of the conference the plenary speaker was Professor Michael Lang, from the Vienna University of Economics and Business Administration who spoke to his paper entitled '*The Variety and Complexity of Allocation Rules in the OECD Model Convention - Is there a need for such Complexity*'. The Honourable Mr Justice Richard Edmonds, Federal Court of Australia presented the plenary session on the third day delivering his paper entitled '*Recourse to Foreign Authority in Deciding Australian Tax Cases*'.

The conference theme 'The Pursuit of Simplicity – Simply Impossible?' generated considerable interest from conference delegates which included tax academics, policy makers and practitioners across both Australia and New Zealand. The papers in this edition of *JATTA* demonstrate the enormous and ongoing challenge that complexity in our tax regime presents. I believe that these papers make a valuable contribution to the literature and stimulate the engagement and contribution of others to improving our respective tax systems.

Finally, the efforts of all of the members of ATTA made the 19th Annual Conference the great success that it was culminating in the publication of this edition of peer reviewed papers. In particular, I wish to thank the authors, referees and members of the editorial board of *JATTA*. ATTA is an organisation that plays an important role in the ongoing taxation debate. No doubt its contribution will continue to be recognised as significant.

Kerrie Sadiq (University of Queensland)

7 January 2008

PART IVA: THE RELEVANCE OF SUBJECTIVE PURPOSE IN DRAWING THE CONCLUSION UNDER SECTION 177D

DOMENIC CARBONE*

It is beyond question that the schemes to which the general anti-avoidance provisions in Pt IVA of the Income Tax Assessment Act 1936 (Cth) apply are intended to be determined by an objective test or inquiry under s 177D. This was initially made clear at least by the Explanatory Memorandum to Pt IVA, if not by the text of the provisions. The Explanatory Memorandum stated that the provisions of Pt IVA were designed to apply where, on an “objective view” of a particular arrangement, its features and its surrounding circumstances, the conclusion as to sole or dominant purpose would be reached under s 177D(b).¹ It is widely thought that this objective test or inquiry leaves no room to consider the subjective purpose, intention or motive of a taxpayer or others who enter into or carry out a scheme.² This article discusses whether this proposition is correct by undertaking a review of court cases in which the issue has been addressed. By way of introduction to the discussion, an outline of Pt IVA is provided and some observations are made on the meaning of subjective purpose, intention and motive.

I INTRODUCTION

A Outline of Pt IVA

The application of the general anti-avoidance provisions in Pt IVA is governed by s 177D. Basically, the provisions can apply to a scheme where:

- (a) a taxpayer has obtained a tax benefit in connection with the scheme, and
- (b) having regard to the factors listed in s 177D(b), it would be concluded that a person who entered into or carried out that scheme, or a part of it, did so for the purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme.

The provisions of Pt IVA are not, however, self-executing and do not simply apply of their own force. To enliven the provisions the Commissioner of Taxation must first exercise the discretion under s 177F to make a determination to, broadly speaking, cancel a tax benefit to which Pt IVA applies. The making of such a determination is therefore the “pivot” upon which the operation of Pt IVA turns.³

Under s 177F(1), there are two prerequisites to the Commissioner being able to exercise the discretion to make a Pt IVA determination. The two prerequisites are:

- 1 A tax benefit has been obtained by a taxpayer in connection with a scheme; and

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¹ House of Representatives, *Income Tax Laws Amendment Bill (No 2) 1981*, Explanatory Memorandum at 2 and 12.

² See for example the *Australian Tax Handbook 2007*, Deutsch et al, at [44 210]. It can be noted at the outset that this approach could be considered to be contrary to that suggested by the Explanatory Memorandum. At 2, it is stated that one of the limitations on the former general anti-avoidance provisions in s 260, that Pt IVA was intended and designed to overcome, was that s 260 did not allow an enquiry into the “purposes or motives” of persons entering into an arrangement. Rather, the enquiry under s 260 was limited to examining only the arrangement itself. Therefore, on one view it can be said that the Explanatory Memorandum indicates that Pt IVA was intended, amongst other things, to allow an enquiry into a person’s “purpose or motive”. It must be acknowledged, however, that this view is not free from doubt and there may be disagreement on the point.

³ *FCI v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 413.

2 The scheme is one to which Pt IVA applies.

It is the second of these prerequisites that is more important to this article.

A scheme is one to which Pt IVA applies if the conclusion under s 177D(b) can be drawn having regard to its listed factors. The factors are:

- i) the manner in which the scheme was entered into or carried out;
- ii) the form and substance of the scheme;
- iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- iv) the result in relation to the operation of this Act that, but for Pt IVA, would be achieved by the scheme;
- v) any change in the financial position of the taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- vi) any such change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the taxpayer;
- vii) any other consequence for the taxpayer or that connected person of the scheme having been entered into or carried out; and
- viii) the nature of any connection (whether of a business, family or other nature) between the taxpayer and that connected person.

The conclusion to be drawn, having regard to these eight factors, is the conclusion of a “reasonable person”. The relevant question is whether, having regard to those factors, a reasonable person would conclude that a person entered into or carried out the scheme, or a part of it, for the purpose of enabling the taxpayer to obtain a tax benefit in connection with the scheme.⁴

Where a scheme or part of it is entered into or carried out by a person for more than one purpose, the required conclusion is as to the person’s dominant purpose.⁵ A dominant purpose is the “ruling, prevailing or most influential purpose”.⁶ There is no definition, however, of the word “purpose” either in Pt IVA itself or elsewhere in the 1997 or 1936 *Income Tax Assessment Acts*.⁷

B Purpose, intention and motive

The *Macquarie Dictionary* defines “purpose” as: “1. the object for which anything ... is done ... 2. an intended or desired result; end or aim. 3. intention ...”. These meanings may be compared with those of “intention”, which is defined as: “1. the act of determining mentally upon some action or result; a purpose ... 2. the end or object intended”. The meanings of purpose and intention can also be compared with the definition of the word “motive”: “1. something that prompts a person to act in a certain way ... 2. the goal or object of one’s actions”. The definitions of all three words indicate that there is some overlap between their ordinary meanings, particularly the words “purpose” and “intention”. On the other hand, the primary meanings of these two words – essentially the intended object, end or result of an act – can be contrasted with the primary meaning of “motive”, which is concerned more with the reasons why an act is done.

⁴ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 422.

⁵ See s 177A(5) of the *Income Tax Assessment Act 1936* (Cth).

⁶ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 416. Interestingly, this meaning of “dominant” is different to that given in the Explanatory Memorandum at 8 of “a purpose that outweighs all other purposes put together”.

⁷ It is perhaps worth noting that in *Newton v FCT* (1958) 98 CLR 1 at 8, the Privy Council said the word “purpose”, in the former s 260 of the *Income Tax Assessment Act 1936* (Cth), meant “not motive, but the effect which it is sought to achieve – the end in view.”

That there is a difference between the meanings of “purpose” and “motive” was pointed out by Gibbs J in *XCO Pty Ltd v FCT*.⁸ The taxpayer took an assignment of debts owed by a loss company that had been taken over by the holding company of the taxpayer. It was intended at the outset that a small amount of a debt would be repaid to the loss company immediately, which would result in a profit, so that a ruling could be obtained from the Commissioner as to whether debt repayments would be taxable. Gibbs J held that the amount was assessable income under the second limb of the former s 26(a). In reaching this decision, his Honour rejected an argument by the taxpayer that the purpose of making the profit was only to obtain the tax ruling. His Honour said:⁹

To attribute any weight to this fact would be to confuse motive with purpose. The purpose of the scheme was to make a profit, even though the motive for making the profit was to lay the foundation for a test case. It hardly needs saying that the motive with which a profit is made is irrelevant to the question whether the scheme which yielded the profit was a profit-making scheme.

The meanings of “purpose” and “motive” were commented on by Brennan J in *Magna Alloys and Research Pty Ltd v FCT*.¹⁰ His Honour first acknowledged that their meanings are not always clear and that the word “purpose” is susceptible of ambiguity. He agreed with Lord Wright in *Crofter Hand Woven Harris Tweed Co Ltd v Veitch* who had said the “words ‘motive’, ‘object’, ‘purpose’, are in application to practical matters difficult strictly to define or distinguish.” Lord Wright also said that “motive” is often used as meaning “purpose”.¹¹ Lord Simon LC in that case also observed that confusion may arise from such words as “motive” and “intention” which had been used interchangeably in the past.¹²

Brennan J then acknowledged the distinction between “motive” and “purpose”, as well as a distinction between two types of purpose – objective and subjective – as follows:

... Motive means ... the reason why a taxpayer decides to incur the expenditure. Purpose may be either a subjective purpose – the taxpayer’s purpose – where it means the object which the taxpayer intends to achieve by incurring the expenditure; or it may be an objective purpose, meaning the object which the incurring of the expenditure is apt to achieve. Both motive and subjective purpose are states of mind and they are to be distinguished from objective purpose, which is an attribute of a transaction. An objective purpose is attributed to a transaction by reference to all the known circumstances; whereas subjective purpose and motive, being states of mind, are susceptible of proof not by inference alone but also by direct evidence, for a state of mind may be proved by the testimony of him whose state of mind is relevant to a fact in issue.

In saying this, his Honour was addressing the relevance of purpose and motive to ascertaining deductibility under the former s 51(1). Further, what he said about objective purpose was in the context of the purpose of a transaction and not of a person. Nevertheless, it is considered that the statement supports that where a subjective purpose or a motive is to be determined regard can be had to a person’s testimony as to their actual state of mind, as well as to all the known circumstances. A conclusion as to subjective purpose or motive may therefore be proved by direct evidence from the person as well as by inference from the known circumstances. This approach differs from that in determining an objective purpose, in which case such a purpose is to be attributed or inferred only by reference to those circumstances. Accordingly, evidence of a person’s actual state of mind would be irrelevant to determining an objective purpose on the basis that it is not a known circumstance.

Finally, it may be noted that the courts do accept that a person’s testimony may be the best evidence of their subjective purpose, object or state of mind in entering into a transaction.

⁸ (1971) 124 CLR 343.

⁹ (1971) 124 CLR 343 at 350-351.

¹⁰ (1980) 49 FLR 183 at 185.

¹¹ [1942] AC 435 at 469.

¹² [1942] AC 435 at 444 where his Honour referred to Lord Dunedin in *Sorrell v Smith* [1925] AC 700 at 724.

However, such evidence has to be tested “most closely, and received with the greatest caution”.¹³ A reason for testing such evidence closely before accepting it is that a person’s recollection as to a past state of mind is apt consciously or unconsciously to be distorted and at times be unreliable.¹⁴ Another reason is that such evidence is often self-serving and should therefore be approached with a degree of scepticism unless it is supported by other independent corroborating evidence. Consequently, it may be said that a person’s testimony is not decisive of the conclusion on their subjective purpose, object or state of mind. That testimony must still be examined against and judged in light of the known circumstances of a case. In view of this, subjective purpose could be more accurately referred to as subjective purpose determined objectively.

II SCHEMES TO WHICH PT IVA APPLIES – CONCLUSION ON SOLE OR DOMINANT PURPOSE

As indicated, in drawing the conclusion under s 177D(b) about a person’s sole or dominant purpose, a reasonable person must have regard to the eight factors listed in the paragraph. An issue that arises at the outset is whether the listed factors are exhaustive, so that regard cannot be had to any other factor, or whether the listed factors are merely inclusive, which would allow regard to other factors not listed where they are considered relevant by the reasonable person.¹⁵

On the one hand, it may be noted that the word “only” does not appear after the words “having regard” in the text of s 177D(b). The inclusion of this word would have left little doubt on the issue, so that a reasonable person could have regard only to the listed factors and to no other factors. A more certain outcome would have resulted by the insertion in the text of the words “this is an exhaustive list” (cf s 177EA(18)), or even an express exclusion such as “but without regard to” to a specified factor.¹⁶ On the other hand, it may also be noted that the text of s 177D(b) does not include the expression “without being limited to” or an equivalent expression such as “amongst other factors”, or the words “this is not an exhaustive list”. Again, this would have left little doubt on the issue, but with the contrary outcome. Further, the text does not include as a listed factor “any other relevant circumstances”, which would have similarly allowed regard to other factors not listed as long as they are considered relevant.¹⁷

The second and related issue that arises is what regard, if any, can be had to the subjective purpose, intention or motive of a person in drawing the conclusion under s 177D(b). In other words, can any regard be had to a person’s actual state of mind as to their object or intended result, or as to why the person acted as they did. Such matters are not expressly included in the text of the factors listed in s 177D(b). The question is then whether or not this forecloses the answer to the issue.

The following cases assist in providing the answers to these two issues.

A Peabody

¹³ *Pascoe v FCT* (1956) 11 ATD 108 at 111, per Fullagar J where his Honour also cited Cussen J in *Cox v Smail* [1912] VLR 274 at 283.

¹⁴ *Gauci v FCT* [1975] HCA 54; (1975) 135 CLR 81 at 86.

¹⁵ cf *Minister for Aboriginal Affairs v Peko-Wallsend Ltd* (1986) 162 CLR 24 at 39.

¹⁶ See for example s 82KJ of the *Income Tax Assessment Act 1936* (Cth) which has the exclusion “(but without regard to any benefit relating to the [acquisition](#) or possible [acquisition](#) of the [property](#) referred to in paragraph (c))”.

¹⁷ cf s 165-15(1) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

The two issues just mentioned were first addressed by Hill J in the Full Federal Court in *Peabody v FCT*.¹⁸ The case involved the application of Pt IVA to a scheme involving a conversion of purchased shares that resulted in their value shifting to other shares already held by the trustee of a family trust of which the taxpayer was a beneficiary. Another result of the share conversion was to avoid the possible application of the former s 26AAA that would have included in assessable income a profit arising from a sale by the trustee into a public float of the unconverted purchased shares, if the sale had happened within 12 months of their purchase.

Hill J (with whom Ryan and Cooper JJ agreed) made the following observation on the two issues:¹⁹

It will be seen that the determination of what schemes fall within s 177D requires an objective conclusion to be drawn, having regard to the matters referred to in par (b) of the section, but no other matters. It is notable that the actual subjective purpose of any relevant person is not a matter to which regard may be had in drawing the conclusion.

This observation ruled out, in absolute terms, any regard being had to actual subjective purpose in drawing the conclusion under s 177D(b) because that type of purpose is not listed as one of the factors in the section. The observation was not, however, material to Hill J's decision that the requisite conclusion as to dominant purpose could not be drawn where the scheme involving value shifting of the purchased shares, also encompassed the financing of that share purchase by the issue of redeemable preference shares and the ultimate floatation of a public company.²⁰ The relevance of a person's actual subjective purpose to this conclusion was not at issue in the case. Therefore, his Honour's observation about the relevance of that purpose was obiter in nature.

On the appeal to the High Court,²¹ the case was decided without the Court having to address whether the requisite conclusion as to dominant purpose under s 177D(b) could be drawn. However, the High Court did decide that the existence of the Commissioner's discretion to cancel a tax benefit under s 177F(1) does not depend on the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connection with a Pt IVA scheme. Rather, the High Court held that those are "posited as objective facts".²² Consequently, an error made by the Commissioner in identifying a scheme as being one to which Pt IVA applies, or as to the connection of a tax benefit with such a scheme, will result in the wrongful exercise of the discretion under s 177F(1) only if the tax benefit cancelled by the Commissioner is not a tax benefit within the meaning of Pt IVA. Put in another way, the correct application of Pt IVA is not determined by the Commissioner's opinion as the existence of its required elements. Rather, it is determined by an "objective" assessment of the facts irrespective of any opinion or view held by the Commissioner.

¹⁸ *Peabody v FCT* (1993) 40 FCR 531.

¹⁹ *Peabody v FCT* (1993) 40 FCR 531 at 542.

²⁰ Hill J instead concluded that the whole scheme encompassing those steps was entered into or carried out by Mr Peabody with a dominant commercial purpose, namely the acquisition of shares from Mr Kleinschmidt and the floatation of a public company.

²¹ *FCT v Peabody* [1994] HCA 43; (1994) 181 CLR 359.

²² *FCT v Peabody* [1994] HCA 43; (1994) 181 CLR 359 at 382.

B Spotless Services

An objective approach to the interpretation and application of the prerequisites to the Commissioner exercising the discretion to make a Pt IVA determination was confirmed and further developed by the High Court in *FCT v Spotless Services Ltd*.²³ There the taxpayers were Australian resident companies that invested surplus funds in the Cook Islands. The investment was made by the taxpayers sending an officer to the Cook Islands who drew a cheque for the amount invested and delivered it to a Cook Islands bank. On maturity the invested funds plus interest (less Cook Islands withholding tax levied at 5%) were paid to the companies in Australia. The taxpayers sought to take advantage of the former s 23(q) to achieve an increased after tax return, since the interest income would be exempt from tax in Australia.²⁴ Even though the Cook Islands interest rate actually payable was about 4% below the Australian bank bill rate, the after tax return would have been greater than that achievable by investing in Australia because the Cook Islands interest would have been exempt from tax in Australia.

In a joint judgment, Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ confirmed an objective approach to the interpretation and application of the prerequisites to the Commissioner making a Pt IVA determination by starting with the approach laid down in *Peabody*, namely that the existence of a tax benefit obtained in connection with a Pt IVA scheme is posited as an “objective fact”, and then referring to the eight factors listed in s 177D(b) as “objective criteria” and to matters that answer their description as “objective facts”. Their Honours said:²⁵

The Commissioner is empowered to make a determination only where the objective criteria specified in par (b) of s 177D are met. In particular, it is necessary that the taxpayer has obtained a “tax benefit” in connection with a “scheme” to which Pt IVA applied. This litigation requires determination of a dispute as to whether, in respect of the taxpayers in question here, those objective criteria were met.

Later their Honours said:²⁶

The eight categories set out in par (b) of s 177D as matters to which regard is to be had “are posited as objective facts”. That construction is supported by the employment in s 177D of the phrase “it would be concluded that ...”.

In saying this, their Honours applied to s 177D(b) what the Court in *Peabody* had said in the broader context of addressing the nature of the prerequisites to the Commissioner making a determination to apply Pt IVA.

While the High Court in *Spotless Services* did not expressly address the issue of the relevance of the subjective purpose of a person to the conclusion on dominant purpose under s 177D(b), it may be noted that at first instance²⁷ Lockhart J made a similar observation to that made by Hill J in *Peabody*. Lockhart J said:

Of the eight circumstances listed in [s 177D(b)] to which the Commissioner must have regard, none of them involves the subjective purpose or intent of a person to obtain a tax benefit; the circumstances predicate objective tests.

On the appeal, the High Court neither approved nor disapproved of Lockhart’s observation on the issue.

²³ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404.

²⁴ At the time, the effect of s 23(q) was that the interest income received from the investment was exempt from income tax in Australia if it had been derived from a source in the Cook Islands and was not exempt from tax there.

²⁵ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 413-414.

²⁶ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404 at 421- 422.

²⁷ *Spotless Services Ltd v FCT* 93 ATC 4397 at 4418.

C CC (New South Wales)

In *CC(New South Wales) Pty Ltd (in liq) v FCT*,²⁸ the taxpayer was a construction company that was appointed to manage the construction of a multi-storey residential apartment building project being undertaken by Quay Apartments Pty Ltd (QA) as trustee of a unit trust. The principal unit holder and financier of the unit trust went into receivership and the taxpayer's parent, Concrete Constructions Pty Ltd (CC), acquired the units in the trust and the shares in QA, and assumed all of QA's liabilities. At that time, the unit trust had accumulated tax losses of \$50,000. The apartment building project was completed and at the end of that income year the accounts of the unit trust showed accumulated tax losses of \$6.427 million. The taxpayer then secured other construction management contracts and purported to enter into those contracts as agent for QA, in that company's capacity as trustee of the unit trust, under an undisclosed principal-agent agreement. The taxpayer claimed that the income paid to it under the contracts was derived by QA and could be offset against the past year tax losses of the unit trust. The Commissioner made determinations under Pt IVA and issued amended assessments that included the construction management contract income in the assessable income of the taxpayer.

The taxpayer's appeal to the Federal Court challenging the amended assessments was dismissed. Sackville J upheld the Commissioner's argument that the agency agreement made between the taxpayer and QA was ineffective in law to create the relationship of agent and principal. Although it was not strictly necessary to do so, his Honour also decided that, had the agency agreement been effective, the appointment of the taxpayer as agent of QA and the performance of the construction management contracts was a scheme to which Pt IVA would have applied.²⁹

In reaching this decision, Sackville J noted that an argument put by the taxpayer about the commerciality of the scheme, being to provide liquidity to QA to assist it to meet its liabilities, was based on the actual motivation of persons involved being relevant to the question posed by s 177D(b). His Honour rejected the basis of this argument and cited Hill J's observation in *Peabody* as support for this. Sackville J also considered that the observation was consistent with the way the joint judgment *Spotless Services* stated the question to be answered under s 177D(b).³⁰

D Eastern Nitrogen

The taxpayer in *Eastern Nitrogen Ltd v FCT*³¹ entered into a sale and leaseback transaction with financiers under which it sold plant to the financiers and leased it back for five years in return for rental payments. At the end of the lease the taxpayer was to buy back the plant at an agreed residual value. The taxpayer claimed deductions for the rental payments, as well as valuation and establishment fees. The Commissioner made a determination under Pt IVA disallowing part of the deductions.

At first instance, the Federal Court dismissed the taxpayer's challenge to the validity of the Pt IVA determination.³² Drummond J held that the sale and leaseback transaction was a scheme to which Pt IVA applied because the taxpayer's dominant purpose in entering into the

²⁸ *CC (New South Wales) Pty Ltd (in liq) v FCT* 97 ATC 4123.

²⁹ However, Sackville J's reasons for holding that Pt IVA would have applied were stated more briefly than if the application of Pt IVA had been the only live issue in the case.

³⁰ *CC (New South Wales) Pty Ltd (in liq) v FCT* 97 ATC 4123 at 4146-4147.

³¹ *Eastern Nitrogen Ltd v FCT* [2001] FCA 366; (2001) 108 FCR 27.

³² [1999] FCA 1536; 99 ATC 5163.

scheme was to obtain tax benefits in the form of deductions for the lease rental payments. In his reasons, his Honour analysed extensive evidence relating to the taxpayer's subjective purpose for entering into the transaction. He concluded that the taxpayer's dominant purpose, in the sense of its subjective purpose for entering into the transaction, was to obtain the tax benefit available from the full deductibility of the rental payments.

In response to a submission by the Commissioner that evidence of subjective intention, and as to what was sought to be achieved from the transaction, was irrelevant to the conclusion under s 177D(b), Drummond J said the following:³³

79 In my opinion, the Commissioner goes too far in submitting that evidence of the Eastern Nitrogen witnesses who were involved in considering and agreeing upon the sale and lease back transaction as to their subjective intentions and as to what they sought to achieve for Eastern Nitrogen from the transaction is irrelevant to consideration of whether the conclusion referred to in s 177D is established. I reach this view with hesitation, given the contrary conclusion of Sackville J in *CC (New South Wales) Pty Ltd (In Liq) v Federal Commissioner of Taxation* (1997) ATC 4,123 at 4,146 - 4,147. But as Sackville J there pointed out, neither in *Federal Commissioner of Taxation v Peabody* (1994) [181 CLR 359](#) nor in *Spotless* has the High Court expressly considered the point. ...

80 Evidence of the subjective intentions of scheme participants is, I think, well capable of assisting in the proper understanding of the activities engaged in and well capable in other ways of being relevant, at least to proof of the matter or issue the subject of s 177D(b)(i), in view of the wide meaning the term "manner" was said to have in *Spotless* at 420.

In *Spotless Services*, the High Court had said that manner "includes consideration of the way in which and method or procedure by which the particular scheme in question was established".

The taxpayer's further appeal to the Full Federal Court was allowed with the Court holding that Pt IVA did not apply because the taxpayer's dominant purpose in entering into the sale and leaseback transaction was to not to obtain a tax benefit. Rather, the dominant purpose was to obtain a very large financial facility on the best terms reasonably available. Carr J (with whom Sundberg J agreed) further specifically held that the primary judge had erred in law in adopting an approach to determining dominant purpose under s 177D which allowed subjective intention to be considered where it assists in understanding activities engaged in and is relevant to proof of "manner" in s 177D(b)(i).³⁴ Carr J expressed the view that the conclusion required by s 177D was not directed at a person's actual dominant purpose or motive but to the purpose as objectively assessed. The person's subjective state of mind was therefore not relevant for the purposes of Pt IVA.³⁵

E Consolidated Press Holdings

In *FCT v Consolidated Press Holdings Ltd*,³⁶ the taxpayer was to invest in two associated foreign resident companies that would participate in the takeover of a company in the United Kingdom. The investment was to be made as equity that would give rise to dividends that might carry United Kingdom tax credits or be tax exempt. To use this tax relief it was necessary for the Australian resident company receiving the dividends to be in a taxable position. This might not have been the case if the Australian resident company had substantial Australian borrowings. Relying on the advice of its accountant, Mr Cherry, another Australian resident company (MLG) was inserted between the taxpayer and the

³³ [1999] FCA 1536; 99 ATC 5163 at 5179.

³⁴ *Eastern Nitrogen Ltd v FCT* [2001] FCA 366; (2001) 108 FCR 27.

³⁵ *Eastern Nitrogen Ltd v FCT* [2001] FCA 366; (2001) 108 FCR 27 at 44 [82] and 45 [87-88].

³⁶ *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235.

associated companies. The taxpayer then borrowed money and used the borrowings to subscribe for shares in MLG. In turn, MLG invested in the associated companies and tax credit relief was available to MLG.

Another consequence of this structure was that the interest deductions on the taxpayer's borrowings were immediately deductible, rather than being quarantined by s 79D. Under s 79D, a deduction that related to foreign source income was limited to the amount of that income and any excess deduction is carried forward. The effect of s 79D and this consequence had not been referred to in the accountant's advice and had not been considered by the companies. However, the accountant had previously been advised by counsel and believed that s 79D did not apply to the type of structure adopted.

At first instance in the Federal Court,³⁷ Hill J held that Pt IVA applied to the scheme involving the acquisition by the taxpayer of shares in MLG and the acquisition by MLG of shares in the associated companies. In regard to the conclusion to be drawn under s 177D(b), his Honour noted:³⁸

As the High Court pointed out in *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) [186 CLR 404](#) the conclusion which is to be drawn under s 177D depends entirely upon objective facts. Subjective motivation will be irrelevant to the conclusion. Hence, whether or not Mr Cherry or others had a purpose of ensuring tax deductibility to [the taxpayer] of the interest deductions to which it was otherwise entitled would not be relevant in arriving at that conclusion.

His Honour concluded (but with some doubt) that the dominant purpose of the taxpayer's advisors was to bring about the result that a deduction would be allowed to the taxpayer which, but for the scheme, would not have been allowable because of the application of s 79D. He reached this conclusion because the interest deduction was more immediate than the adoption of a neutral structure for non interference with tax credits.³⁹

The taxpayer challenged Hill J's decision on Pt IVA in appeals to the Full Federal Court⁴⁰ and then the High Court⁴¹ but both challenges were dismissed. Before the Full Federal Court, one of the grounds on which the taxpayer attacked Hill J's reasoning on Pt IVA was that his Honour failed to have regard to all the factors set out in s 177D(b) in reaching his conclusion that Pt IVA applied. The Full Federal Court dealt briefly with this ground of attack as follows:⁴²

In ACP's submission, it was said that these were "the only matters to be taken into account". That latter proposition is not warranted by the language of the section or by the characterisation of the eight matters as "necessary" to be taken into account.

The Court did not further expand on its reasons for this conclusion, given its view that the argument was not really apposite to the main thrust of the taxpayer's appeal on Pt IVA.

On the taxpayer's appeal to the High Court, the taxpayer argued that, as neither the accountant nor the companies involved had considered the application of s 79D, it was difficult to say the scheme was entered into to avoid the section. In addition, the taxpayer argued that it was impermissible to attribute the accountant's purpose to the taxpayer. The Commissioner responded by arguing that in applying s 177D one looks to the objective purpose of parties to the scheme and so the accountant's subjective purpose did not matter.

In a unanimous decision, the High Court dismissed the appeal and held that the scheme was one to which Pt IVA applied as a dominant purpose of a person who participated in the scheme, including the taxpayer's advisor, was for the taxpayer to obtain a tax benefit. In

³⁷ *CPH Property Pty Ltd v FCT* [1998] FCA 1276; (1998) 88 FCR 21.

³⁸ *CPH Property Pty Ltd v FCT* [1998] FCA 1276; (1998) 88 FCR 21 at 41.

³⁹ *CPH Property Pty Ltd v FCT* [1998] FCA 1276; (1998) 88 FCR 21 at 42.

⁴⁰ *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199; (1999) 91 FCR 524.

⁴¹ *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235.

⁴² *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199; (1999) 91 FCR 524 at 552 [94].

doing so, the High Court noted, but without expressly approving or disapproving, that Hill J had applied the decision in *Spotless Services* in observing that the conclusion to be drawn under s 177D depends on objective facts and is not concerned with subjective motivation of a person who entered into or carried out a scheme or a part of it.⁴³

In regard to Hill J's conclusion about the dominant purpose of the taxpayer's advisor, which was upheld by the Full Federal Court, the High Court said that attributing the purpose of an advisor to a person who entered into or carried out a scheme was justifiable and appropriate. The Court pointed out:⁴⁴

In some cases, the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor, in relation to the scheme or part of the scheme, but that does not defeat the operation of s 177D. If, in the present case, there had been evidence which showed that no director or employee of any member of the Group had ever heard of s 79D, that would not conclude the matter in favour of the taxpayer. One of the reasons for making s 177D turn upon the objective matters listed in the section, it may be inferred, was to avoid the consequence that the operation of Pt IVA depends upon the fiscal awareness of a taxpayer.

Although it does not appear to be entirely clear that the High Court was referring to the professional advisor's objective purpose, as opposed to their subjective purpose, that this is so is supported by the Court's reference to s 177D turning on objective matters. It is further supported by the Court's conclusion that the advisor's dominant purpose was for the taxpayer to obtain a tax benefit even though the advisor had not considered the application of the section that had been avoided by the scheme to result in the tax benefit.

F Zoffanies

The question of whether subjective intention can be taken into account under s 177D was directly at issue in *FCT v Zoffanies Pty Ltd*.⁴⁵ In that case, Macquarie Bank Ltd (MBL) and its subsidiaries entered into a research and development syndicate. A subsidiary, MS3, paid the owner of technology used in the syndicate a licence fee and paid interest on funds borrowed to pay the fee. As a result of deductions for the licence fee and interest, MS3 incurred a loss and it transferred that loss to the taxpayer, another subsidiary of MBL. The taxpayer claimed part of the transferred loss as a deduction. The Commissioner made a determination under Pt IVA against MS3 that reduced to nil its deductions for the licence fee and interest. The Commissioner also issued an amended assessment that reduced to nil the taxpayer's claim for the transferred loss.

On a review by the Administrative Appeals Tribunal (AAT),⁴⁶ it found in favour of the taxpayer and held that Pt IVA did not apply. The AAT was of the view that while MS3 obtaining a tax benefit was undoubtedly an important purpose of the scheme, a reasonable person would conclude that it was not the dominant purpose. Rather, the dominant purpose was the making of an investment in the syndicate. In reaching this conclusion, the AAT relied particularly on the evidence of an employee of MBL who could be seen to be the relevant mind of the taxpayer, including "his stated reasons" for MBL's and MS3's involvement in the syndicate.⁴⁷

On the appeal to the Full Federal Court,⁴⁸ one of the Commissioner's arguments was that the AAT erred by applying a wrong test in reaching the conclusion it drew under s 177D.

⁴³ *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235 at 263 [89].

⁴⁴ *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235 at 264 [95].

⁴⁵ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236; (2003) 132 FCR 523.

⁴⁶ *Zoffanies Pty Ltd v FCT* [2002] AATA 758; 2002 ATC 2129.

⁴⁷ *Zoffanies Pty Ltd v FCT* [2002] AATA 758 [171]; 2002 ATC 2129 at 2157 [171].

⁴⁸ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236; (2003) 132 FCR 523.

Specifically, it was submitted the AAT applied a test of subjective purpose rather than an objective test of purpose, as required by s 177D. The Full Federal Court agreed and held that the AAT had applied the wrong test to s 177D. The Court set aside the AAT's decision on the application of Pt IVA and remitted the proceeding to the AAT to apply the correct objective test of purpose in determining whether Pt IVA applied.

Hill J in the Full Court referred to the conclusion as to dominant purpose required under s 177D and said:⁴⁹

... it is clear from the terms of the section itself that that conclusion is one that must be reached having regard to the eight matters stipulated in s 177D(b) and no other matters. It follows that while the conclusion required to be drawn is one that requires consideration of the purpose or dominant purpose of a person, including the taxpayer, that conclusion can not take into account evidence of the actual purpose of a taxpayer or other person, save and except so far as that could be forensically relevant to any one of the matters specifically referred to in s 177D(b) for example, the manner in which the scheme was entered into. None of the eight matters refer to the actual purpose of any person. It also follows that generally, at least, evidence of what may be referred to as the actual or subjective purpose of the taxpayer is irrelevant. However, it may well be the case, as in the present circumstances, that evidence of subjective purpose might be admissible for the purpose of the determining some other issue in the case, for example, here, the provisions dealing with deductions for research and development expenditure. ...

54 It is sometimes said that the conclusion under s 177D is a conclusion of objective purpose. That way of putting it is correct if what is meant by it is that the conclusion is not one drawn from evidence of the actual purpose of the relevant taxpayer or other taxpayers.

...

This general and therefore more relaxed approach of Hill J to the relevance of actual or subjective purpose can be contrasted with the approach of Gyles and Hely JJ. In the judgment of Gyles J (with whose reasons Hely J agreed), his Honour stated his reasons in absolute terms in deciding that the AAT had erred in law by taking into account findings as to the actual purpose and motive of the taxpayer in considering the dominant purpose under s 177D(b). His Honour added⁵⁰ that he had:

no great surprise at the nature of the error. The difference between the actual purpose of a taxpayer, on the one hand, and the purpose which is to be imputed to the taxpayer based upon an exclusive set of criteria, on the other hand, is not without subtlety and has been misunderstood before.

G Sleight

The taxpayer in *FCT v Sleight*⁵¹ invested in a tea tree oil project that involved him carrying on a tea tree farming business by engaging a managing company. To make the investment, the taxpayer entered into a loan with a finance company under which repayments of principal were to be met only from the net profit of the farm business. The loan funds were not actually advanced to the taxpayer but were paid on his behalf under a "round robin" finance arrangement that involved cheques being drawn to the managing company, to pay the taxpayer's management and other fees, and then back to the finance company. None of the funds were actually spent in the business operations. The managing and finance companies were connected with the promoter of the project.

At first instance in the Federal Court,⁵² Nicholson J held that Pt IVA did not apply to deny the taxpayer deductions for management and certain other fees because the taxpayer's

⁴⁹ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236; (2003) 132 FCR 523 at 538 [53].

⁵⁰ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236; (2003) 132 FCR 523 at 545 [91].

⁵¹ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211.

⁵² *Sleight v FCT* [2003] FCA 896; 2003 ATC 4801.

purpose in entering into the project was not dominantly to obtain a tax benefit. Although his Honour had no doubt that the tax benefit was a significant element in the taxpayer's purpose, he concluded that it was not the ruling, prevailing and most influential purpose. In drawing this conclusion, his Honour relied on the taxpayer being convinced that the project was commercial and that this view formed a fundamental part of his purpose for entering into the project.⁵³

On the Commissioner's appeal to the Full Federal Court,⁵⁴ it was held that the taxpayer was not entitled to deductions for the management and other fees because Pt IVA applied. The taxpayer's dominant purpose for entering into the project was to obtain a tax benefit, given the uncertainty attendant on certain other deductions he had claimed and the uncertainty of the investment yields that might be realised by the project. It was also relevant that the funds borrowed by the taxpayer were not used for the establishment or operation of the plantation, and that his actual cash payments for the project were funded out of a tax refund that resulted from the deductions claimed.⁵⁵

One of the grounds advanced by the Commissioner for challenging the decision on Pt IVA at first instance was that Nicholson J had impermissibly had regard to the taxpayer's subjective purpose in reaching his decision. The Commissioner submitted this was contrary to the authorities that showed the relevant purpose was to be assessed objectively. Hill J (with whose reasons Hely J agreed) implicitly acknowledged the correctness of this submission by setting out, as one of the propositions on the provisions in Pt IVA decided by the High Court and the Full Federal Court, the following:⁵⁶

Part IVA does not authorise consideration of evidence of the subjective purpose or motivation of a particular person. The subjective state of mind of a person is not a matter listed in s 177D(b) to which regard may be had. Rather the section requires consideration of the eight matters listed in s 177D(b) and no other matters. The subjective state of mind of a person is not such a matter. Hence the section seeks to establish the conclusion which would be reached by reference to what may be referred to as objective factors, that conclusion being however, a conclusion as to the purpose of a person who entered into or carried out the scheme ...

Carr J expressed a similar view in saying that the assessment of the factors in s 177D(b) is not intended to result in a factual finding about a person's actual dominant purpose and so the subjective purpose of the person is not relevant.⁵⁷ His Honour then specifically addressed the primary judge's reliance on the taxpayer being convinced the project was commercial, and on this view forming a fundamental part of the taxpayer's purpose for entering into it, and he said that this indicated an impermissible reliance on the subjective purpose or motivation of the taxpayer.⁵⁸

⁵³ *Sleight v FCT* [2003] FCA 896; 2003 ATC 4801 at 4824[145].

⁵⁴ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211.

⁵⁵ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211 at 235 [94].

⁵⁶ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211 at 229 [67].

⁵⁷ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211 at 253 [205].

⁵⁸ *FCT v Sleight* [2004] FCAFC 94; (2004) 123 FCR 211 at 257 [238].

H Hart

In *FCT v Hart*,⁵⁹ the taxpayers wanted to buy a new home to live in and refinance their existing home to become a rental property. They obtained a loan marketed by a bank as a “wealth optimiser” product that had two main features. The first feature was that the loan could be split into two facilities. The taxpayers used one facility to buy a new home and the other was used to refinance the loan on their existing home, which then became a rental property. The product also had the feature that allowed a borrower to elect that all repayments on the loan be directed to the home loan facility. This allowed the home loan (or non-tax deductible portion of the borrowing) to be paid off sooner than would otherwise have been the case. The taxpayers made this election. As no repayments were directed to the rental property loan facility, interest incurred on that facility accrued and was capitalised. The result was that a greater amount of interest was incurred on the rental property loan facility (or the tax-deductible portion of the borrowing) than would have been the case if a borrower had allocated repayments against both the rental property and home loan facilities. The taxpayers claimed a deduction for the total interest on the rental property loan facility.

At first instance in the Federal Court, Gyles J held that Pt IVA applied to the split loan arrangement.⁶⁰ This decision was reversed on the taxpayers’ appeal to the Full Federal Court, which held that the taxpayers entered into the arrangement for the dominant purpose of obtaining a loan to finance the acquisition of a new home and to refinance and lease out the former home.⁶¹ The leading judgment was delivered by Hill J (with whose reasons Conti J agreed) who said of the relevance of subjective purpose to that conclusion:⁶²

the task of the Court is not to consider the subjective purpose of a particular person, whether the taxpayer or a person who entered into or carried out a part of the scheme. The purpose in question is to be determined objectively having regard to the eight factors. This is implicit and probably explicit in the judgment of the High Court in *Spotless* at 423 and the judgment in *Consolidated Press* at [95]. It is explicit in the judgment of the full Court of this Court in *Eastern Nitrogen Ltd v Federal Commissioner of Taxation* 2001 ATC 4164 at 4177 per Carr J, with whom Lee and French [sic]⁶³ JJ agreed.

The Commissioner’s appeal to the High Court⁶⁴ was allowed with the Court holding that the taxpayers’ dominant purpose in entering into the split loan arrangement with the “wealth optimiser” features, and their directing all repayments to the home loan facility, was to obtain a tax benefit of a greater interest deduction. Although three separate judgments were delivered and it is difficult to extract from them a clear ratio for the decision, a common strand to their reasoning was that the “wealth optimiser” features of the arrangement were explicable only by the tax benefit obtained.

In the High Court, only Gummow and Hayne JJ expressly dealt with the relevance of subjective purpose or motive to the conclusion required under s 177D(b). After initially stating that “the inquiry required by Pt IVA is an objective, not subjective, inquiry”,⁶⁵ their Honours said:⁶⁶

statements about why the taxpayers acted as they did or about why the lender (or its agent) structured the loan in the way it was ... are not statements which provide an answer to the question posed by s 177D(b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matters; it does not require, or even permit, any

⁵⁹ *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216.

⁶⁰ *Hart v FCT* [2001] FCA 1547; (2001) 189 ALR 584.

⁶¹ *Hart v FCT* [2002] FCAFC 222; (2002) 121 FCR 206.

⁶² *Hart v FCT* [2002] FCAFC 222; (2002) 121 FCR 206 at 223 [55].

⁶³ The third judge was actually Sundberg J.

⁶⁴ *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216.

⁶⁵ *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216 at 233 [37].

⁶⁶ *FCT v Hart* [2004] HCA 26; (2004) 217 CLR 216 at 243 [65].

inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or any part of it.

Their Honours therefore specifically rejected as being relevant that the taxpayers entered into split loan arrangement because of their desire to buy a new home to live in and refinance their existing home to become a rental property.

I Macquarie Finance

The taxpayer in *Macquarie Finance Ltd v FCT*⁶⁷ was a subsidiary of Macquarie Bank Ltd (MBL) that made a public offer of stapled income securities. These securities consisted of preference shares issued by MBL and loan notes issued by the taxpayer. The object of the issue of the securities was to raise additional capital for MBL. It was a further object that the capital so raised would fall within the category known as Tier 1 capital for the purposes of the minimum capital requirements prescribed by the Australia Prudential Regulation Authority. The greater the proportion of Tier 1 capital in a company meant that the amount of borrowings raised by the company was greater. The taxpayer claimed a deduction for an amount paid as “interest” on the notes. The Commissioner disallowed the claim and the taxpayer applied to have that decision reviewed by the Federal Court.

An issue in the case was whether Pt IVA applied to disallow the “interest” paid on the notes, assuming it was allowable as a general deduction. At first instance,⁶⁸ Hill J held that the “interest”, if it had been an allowable deduction, constituted a tax benefit that the taxpayer obtained from a scheme involving the issue of the securities having particular features that included a payment direction under a procurement agreement. His Honour further held that the scheme was one to which Pt IVA applied.

One of the questions addressed by Hill J was whether it was correct to take into account the raising of Tier 1 capital as a purpose of a person who entered into or carried out the scheme. His Honour referred to the view of Gummow and Hayne JJ in *Hart* that s 177D(b) did not permit or require consideration to be given to subjective motives and said:⁶⁹

That is clearly correct, with respect, but leaves open the question why the objective circumstances including the manner in which the scheme was entered into would not have led to the same conclusion anyway. If the facts had been that the taxpayers first were introduced to the borrowing transaction before they had considered the acquisition of a new residence and using the existing residence for income producing purposes, the point made by their Honours would have been more easily understood. My understanding of the facts in *Hart* does not suggest this to be the case.

Hill J later observed that a strict application of the view taken by Gummow and Hayne JJ in *Hart* might be thought to exclude the raising of Tier 1 capital as a purpose, because it was a subjective matter. However, he did not think it correct to exclude it both because that was not the approach adopted by Gleeson CJ and McHugh J, and perhaps Callinan J, and because the need for Tier 1 capital could be objectively determined.⁷⁰

In regard to the conclusion as to dominant purpose under s 177D(b), Hill J therefore took the view that ultimately the question for decision was whether, having regard to the eight factors in s 177D(b), it would be concluded that the dominant purpose of some person who entered into or carried out the scheme with the particular features was the obtaining for the taxpayer of tax deductions for the “interest”, or whether it would be concluded that the dominant purpose of persons who entered into or carried out the scheme with its particular

⁶⁷ *Macquarie Finance Ltd v FCT* [2005] FCAFC 205; (2005) 146 FCR 77.

⁶⁸ [2004] FCA 1170; (2004) 210 ALR 508.

⁶⁹ [2004] FCA 1170; (2004) 210 ALR 508 at 537 [100].

⁷⁰ [2004] FCA 1170; (2004) 210 ALR 508 at 540 [110].

features was the obtaining of Tier 1 capital.⁷¹ After having regard to the eight factors in s 177D(b), his Honour concluded (with some reluctance) that the taxpayer obtaining a deduction for the “interest” was the taxpayer’s and MBL’s dominant purpose in entering into and carrying out the scheme. Essentially, he was of the view that this purpose outweighed, although only marginally, the commercial purpose of obtaining Tier 1 capital through the issue of the stapled income securities and the commercial attractions associated with debt financing that took that form.⁷²

On the taxpayer’s appeal to the Full Federal Court,⁷³ a majority comprising French and Hely JJ (with Gyles J dissenting) overturned the decision on Pt IVA. The majority held that Pt IVA did not apply because the dominant purpose of the persons who entered into or carried out the scheme was not to obtain a tax benefit in connection with it.

In reaching this decision, Hely J (with whom French J agreed) noted that there may be room for a difference of opinion as to whether Hill J’s findings, that the obtaining of Tier 1 capital through the issue of the stapled securities was a significant purpose of MBL and that there were commercial attractions associated with such debt financing, involved an impermissible inquiry about why MBL structured the transaction in the way it did, as suggested by Gummow and Hayne JJ in *Hart*. However, Hely J was of the opinion that Hill J was correct to conclude that the need for Tier 1 capital and the comparative advantages and disadvantages of debt and equity were matters capable of being objectively determined. Moreover, Hely J pointed out they were matters to which regard may be had in relation to s 177D(b)(vii), which requires consideration of “any other consequence” of the scheme having been entered into or carried out.⁷⁴

Hely J then reviewed all eight factors in s 177D(b) but specifically took into account the commercial purpose of the obtaining of Tier 1 capital and the commercial advantages associated with the debt financing through the stapled securities. His Honour concluded that the dominant purpose of those engaged in the issue of the stapled securities was to secure to the MBL Group all of the commercial advantages associated with debt financing (including, but not limited to tax deductibility of interest) whilst at the same time qualifying as Tier 1 capital.⁷⁵ In this regard, his Honour essentially weighed up differently to Hill J the factors of manner, form and substance, taxation result and other consequences of the scheme.

J Calder

In *Calder v FCT*,⁷⁶ the taxpayer invested in a tea tree oil project and claimed deductions for management fees, farm fees and interest incurred on a limited recourse loan used to fund the investment. The taxpayer’s financial obligation was significantly self-funded as a result of the structure of the investment, and by the immediate and later deductions generating tax savings to cover the cash commitment required without risk to his own funds. Further, the amounts of the fees and the loan were not made by the exchange of cash but by “round robin” type transactions effected by accounting entries in the books of the promoter companies.

At first instance in the Federal Court,⁷⁷ Nicholson J held that Pt IVA applied because the taxpayer’s dominant purpose in entering into the investment was to obtain a tax benefit of the deductions claimed. In reaching this decision, his Honour rejected an argument by the

⁷¹ [2004] FCA 1170; (2004) 210 ALR 508 at 540 [110].

⁷² [2004] FCA 1170; (2004) 210 ALR 508 at 540 [112].

⁷³ [2005] FCAFC 205; (2005) 146 FCR 77.

⁷⁴ [2005] FCAFC 205; (2005) 146 FCR 77 at 132 [212].

⁷⁵ [2005] FCAFC 205; (2005) 146 FCR 77 at 133-138 [215-239].

⁷⁶ *Calder v FCT* [2005] FCAFC 254; (2005) 226 ALR 643.

⁷⁷ [2005] FCA 911; 2005 ATC 4760.

taxpayer that him not relying on his tax refund to make his initial cash investment, and him later making additional cash payments for voluntary harvest levy fees, was objective evidence that supported the taxpayer sought a commercial return from the investment. His Honour dealt with the argument as follows:⁷⁸

These factors favour a finding, not relevant here, that the [taxpayer] had a subjective purpose of seeking commercial returns. They do not objectively support that the [taxpayer] did not enter the scheme for the purpose of obtaining a tax benefit in connection with it as his dominant purpose. These factors are therefore neutral.

The taxpayer's appeal to the Full Federal Court was dismissed. In a joint judgment, the Court comprising French, Stone and Siopis JJ initially pointed out⁷⁹ that the list of factors in s 177D are exhaustive of the considerations relevant to dominant purpose and then said:⁸⁰

Section 177D mandates consideration of an objective purpose. That is to say the purpose which could be inferred by "a reasonable person".

The Court then accepted that the subjective state of mind of a taxpayer or, in the case of a company, the company's directors is irrelevant to the conclusion to be drawn under s 177D(b).⁸¹ Their Honours cited the passage from the judgment of Gummow and Hayne JJ in *Hart* at [65] and added:⁸² It does not follow from the irrelevance of the subjective state of mind of the taxpayer that objective factors, tending to indicate that a particular purpose was subjectively held by a person, may not also be relevant to the determination of the objective purpose which could be inferred by a reasonable person.

The Court later specifically addressed the taxpayer's argument that the primary judge had erred in treating as irrelevant to the determination of the taxpayer's purpose under s 177D(b) his lack of reliance on the tax refund and the payment of the harvest levy fees. The Court held that the primary judge had correctly treated those factors as supporting the finding of a subjective purpose of the taxpayer that was irrelevant. But the Court also pointed out:⁸³

The mere fact that evidence might support a finding of a subjective purpose of seeking commercial returns does not mean that such evidence may not also be relied upon in ascertaining what a reasonable person might have concluded about [the taxpayer's] purpose in investing in the project.

III CONCLUSION

The cases discussed in this article show that, with one exception, the courts have consistently treated the list of eight factors in s 177D(b) as being exhaustive, so that a reasonable person must have regard only to the listed factors and no other factors in drawing the conclusion under the section about a person's sole or dominant purpose. The exception is the Full Federal Court in *Consolidated Press* where the Court briefly stated that such a proposition is neither warranted by the language of s 177D(b) nor by the characterisation of the eight factors as "necessary" by the High Court in *Spotless*.

The cases also show that the courts have consistently approached the issue of the conclusion to be drawn about purpose under s 177D(b) as being a conclusion as to the objective purpose of the person and not their subjective purpose, or their subjective intention or motivation. A person's objective purpose is the purpose that is inferred by a reasonable person⁸⁴, rather than

⁷⁸ [2005] FCA 911; 2005 ATC 4760 at 4771 [57].

⁷⁹ [2005] FCAFC 254; (2005) 226 ALR 643 at 668 [91].

⁸⁰ [2005] FCAFC 254; (2005) 226 ALR 643 at 669 [95].

⁸¹ [2005] FCAFC 254; (2005) 226 ALR 643 at 669 [96]. The Court referred to *Eastern Nitrogen Ltd v FCT* (2001) 108 FCR 27 at 45 per Carr J (Sundberg J agreeing) as authority for this.

⁸² [2005] FCAFC 254; (2005) 226 ALR 643 at 669 [96].

⁸³ [2005] FCAFC 254; (2005) 226 ALR 643 at 671 [105].

⁸⁴ *Calder v FCT* [2005] FCAFC 254; (2005) 226 ALR 643 at 669 [95].

a conclusion as to the person's subjective or actual purpose⁸⁵ or, in other words, their actual state of mind.⁸⁶ It therefore follows, as was pointed out by the High Court in *Consolidated Press*, that the operation of Pt IVA does not depend on the fiscal awareness of a taxpayer, and that the operation of s 177D in particular is not defeated by the fact that parties to a scheme subjectively may not have any purpose at all.⁸⁷

The courts have not, however, been consistent in their approach to the issue of what regard, if any, can be had to the subjective purpose, intention or motivation of a person in drawing the conclusion under s 177D(b) as to objective purpose. Whereas the cases initially indicated that no regard whatsoever could be had to subjective purpose, intention or motivation, the more recent cases indicate a change in that approach. This change may be said to have started with Drummond J in *Eastern Nitrogen* (although his Honour was overruled on appeal) who was of the opinion that subjective intentions of scheme participants is well capable of assisting in the proper understanding of the activities engaged in, and well capable of being relevant under s 177D(b)(i) to prove the "manner in which the scheme was entered into or carried out". The change in approach is then evident in *Zoffanies* where Hill J similarly said that evidence of the actual purpose of a taxpayer or other person cannot be taken into account in drawing the conclusion under s 177D, "save and except so far" as that purpose could be forensically relevant to any of the matters referred to in s 177D(b), for example, the manner in which a scheme was entered into.

The change is also evident in *Macquarie Finance*, although the approach was given a different emphasis, where Hill J initially accepted as clearly correct the view of Gummow and Hayne JJ in *Hart* that s 177D(b) does not permit or require consideration to be given to subjective motives and, consequently, statements about why a taxpayer acted as they did. But Hill J then pointed out that this left open the question why objective circumstances, including the manner in which a scheme is entered into, would not have allowed consideration of why the taxpayer acted as they did. His Honour therefore concluded in *Macquarie Finance* that it was not correct for evidence of the commercial purpose of the form of a transaction, and its associated commercial attraction, to be excluded on the ground that it was a subjective matter. His reasons were, first, this was not the approach adopted by a clear majority in *Hart*, and secondly, that commercial purpose and attraction could be objectively determined. This view by Hill J was upheld by the Full Federal Court where it was also pointed out that evidence of that commercial purpose and commercial attraction was a matter to which regard could be had under s 177D(b)(vii) as "any other consequence" of a scheme having been entered into or carried out.

The change in approach was then confirmed by the Full Federal Court in *Calder* that held, despite the subjective state of mind of a taxpayer being irrelevant to the conclusion to be drawn under s 177D(b), it did not follow that objective factors, tending to indicate that a particular purpose was subjectively held by a person, are not also relevant to determining the objective purpose that could be inferred by a reasonable person. Further, the mere fact that

⁸⁵ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236; (2003) 132 FCR 523 at 538 [54].

⁸⁶ It may be noted that this latter point is not novel under the law. It is similar to the approach that is adopted under Contract Law to determining contractual intention, or the intention to create legal relations or be legally bound. Contract Law is not concerned with the "real" intentions of the parties, but with the "outward manifestations of those intentions": *Taylor v Johnson* (1983) 151 CLR 422 at 428. The objective test in Contract Law is not based on actual intention of the parties but on an inference to be drawn from the subject matter and nature of the agreement, and from other circumstances: *Placer Development Ltd v Cth* (1969) 121 CLR 353 at 367. Therefore, it is not the subjective belief or understanding of the parties that determines the issue. What matters is what a reasonable person in the position the parties would have understood: *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at 179 [40].

⁸⁷ *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; (2001) 207 CLR 235 at 264 [95].

evidence supports a finding of a subjective purpose of seeking commercial returns does not mean that such evidence may not also be relied on in determining what a reasonable person would have concluded about a person's purpose in entering into or carrying out a scheme.

The changed approach is, in the author's view, more desirable than retaining the absolute rule that a person's subjective purpose, intention or motive can never be relevant to drawing the conclusion as to sole or dominant purpose under s 177D(b). The absolute rule leads to an overly technical approach that leaves the court or decision maker unnecessarily restricted or "blinkered" in what can lawfully and properly be considered in reaching the conclusion required under s 177D(b). No good reason is readily apparent for leaving out of consideration evidence of the subjective purpose, intention or motive of a person entering into a scheme, especially where this exposes or reflects on a commercial purpose of the person entering into the scheme that may not otherwise be apparent. Of course, this is always subject to such evidence being relevant to any of the eight factors listed in s 177D(b).

The changed approach can also be said to be consistent with the Explanatory Memorandum in two respects. First, it assists in overcoming one of the limitations on the former general anti-avoidance provision in s 260 of not allowing an enquiry into "the purposes of motives" of persons entering into schemes. Secondly, a person's subjective purpose, intention or motive is arguably part of the surrounding circumstances of a scheme.

But, courts and the decision maker must always bear uppermost in mind that it is not a conclusion about a person's subjective purpose that is to be made under s 177D(b). The required conclusion is as to a person's objective purpose as inferred by a reasonable person having regard to the eight factors listed in the section.

It must be finally said, however, that the changed approach to the relevance of subjective purpose, intention and motivation to the conclusion under s 177D(b) cannot be regarded as settled until the High Court, or least of majority of the court, directly rules on the issue.

AUSTRALIA'S TAXATION REGULATION IMPACT STATEMENTS – HELPING OR HINDERING ACCOUNTABLE REPRESENTATIVE DEMOCRACY?

MARK BURTON*

I INTRODUCTION

The primary purpose of this paper is to critically examine the Australian experience with respect to Regulation Impact Statements (RISs) regarding taxation legislation. The first objective of this critical appraisal is to describe the contemporary Australian elaboration of accountable, representative democratic government which is reflected in taxation regulation impact assessment. The second objective is to demonstrate that the current iteration of the process of taxation regulatory impact analysis reflects a particular, contingent model of 'democratic' government which is neither conducive to meaningful democratic accountability nor consistent with sound policy making. The third objective is to identify mechanisms for overcoming this pathology at the core of the Australian tax legislative process. I will argue that this pathology might be remedied by adopting an alternative role for regulatory impact analysis, one which is framed in terms of meaningfully promoting broad, ongoing public accountability.

Regulation impact assessment emerged out of business resistance to what was portrayed as excessive environmental regulation imposed by 'unaccountable' public officials.¹ Its early proponents hoped that the process of regulatory impact assessment would place the onus upon proponents of new regulation to demonstrate a clear case for imposing another regulatory 'burden' on business – an onus which, the proponents hoped, would rarely be discharged. Regulatory impact analysis was born of a politically conservative urge to stem the regulatory tide and maintain, literally, business as usual.

However, regulatory impact assessment also gained broader support because it fitted comfortably within the discourse of bureaucratic rationality. Following Weber,² a prominent strand of sociological theory holds that the legitimacy of modern democratic states is founded less upon state action that embodies a social consensus upon contingent moral norms³ and more upon a state's capacity to comply with a social consensus upon procedural norms with respect to the process by which public policy is created.⁴ Thus, for example, Tyler suggests that the general public take the procedural aspects of state action as a proxy for the substantive legitimacy of state action. However there are myriad procedural norms for public policy making which might be adopted in a representative democracy, depending upon one's standpoint regarding the most appropriate roles for public officials and 'the public' in a 'democratic' policy making process. The contemporary discourse of public accountability expresses one model of democratic government under which public officials make decisions for which they provide an account, or explanation, to the general public.⁵ If Weber and Tyler are right, the general public assess such accounts upon the basis of the rationality of the

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¹ Thomas O McGarity, *Reinventing rationality: The Role of Regulatory analysis in the federal bureaucracy*, Cambridge Uni Press, Cambridge, 1991, ch 2.

² Max Weber, 'Science as a Vocation' in H.H. Gerth and C.W. Mills (eds), *From Max Weber*, Oxford University Press, Oxford, 1972, 138ff.

³ Seymour Lipset, *Political Man*, Doubleday, New York, 1963.

⁴ Tom R Tyler, *Why People Obey the Law*, 2006, afterword, 282; Amy Gangl, 'Procedural Justice Theory and Evaluations of the Lawmaking Process' (2003) 25 *Political Behavior* 119.

⁵ Michael Dowdle (ed), *Public Accountability*, Cambridge University Press, Cambridge, 2006.

policy making process rather than upon the morality of the substantive policy outcome. Thus, on this view, regulation is legitimate if government can demonstrate the procedural rationality underlying the substantive policies which it implements.

The emphasis upon quantitative and qualitative analysis within the Regulation Impact Statement literature⁶ is central to the portrayal of rational government which can provide a compelling account of rational legislative process. However, notwithstanding the detailed procedures regarding painstaking data collection and cost/benefit analyses, it is arguable that the official discourse of bureaucratic rationality serves the function of legitimising state action by promoting the myth of procedural rationality. Despite the technical capacity of the modern state, absolute truth is elusive when confronting the ‘wicked problems’ of public policy.⁷ Thus, it is doubtful whether an account can ever incontrovertibly demonstrate that a particular course of action is the best available.

‘Pure’ bureaucratic rationality might be a forlorn hope, despite regulatory impact analysis, but this does not mean that it should be abolished. It does mean that the limitations of regulatory impact analysis should be acknowledged and that institutional measures be incorporated within the legislative process with the object of identifying and minimizing arbitrary decision making. With appropriate information, ‘legislators’⁸ should be in a position to achieve better public policy outcomes than would be adopted by ignorant legislators. With appropriate information, legislators should be able to scrutinize the assertions of interest groups made in their claims for tax reform, they should be able to undertake performance reviews of extant legislation and they should be able to develop proposals for reform. Armed with appropriate information which is readily available in an accessible form, the general public would be better placed to call public officials to account in this era of public accountability.

Unfortunately, Australian Commonwealth tax legislation is developed in an environment where public access to credible and appropriate information is, at best, limited. At the end of the twentieth century, the Review of Business Taxation concluded as much,⁹ and the more recent Regulation Review Taskforce indicated that little had changed.¹⁰ One purpose of this paper is to demonstrate that little has changed in this regard by examining recent experience with Regulation Impact Statements. Moreover, this paper argues that little will change as a result of the Government’s draft Regulation Guidelines with respect to taxation Regulation Impact Statements.¹¹ The Australian Government reports that these guidelines comprise a significant innovation in the legislative process in general and the tax legislative process in particular.¹² In fact, if assessed against the norms of rational legislative action embodied in the government’s own guidelines with respect to non-tax legislation, the Australian Regulation Impact Statements with respect to tax legislation are an abject failure. Rather than

⁶ Australian Government, *Best Practice Regulation Handbook*, Productivity Commission, Canberra, 2006.

⁷ The concept of ‘wicked problems’ was elaborated in: Horst Rittel and Melvin Webber (1973), ‘Dilemmas in a General Theory of Planning’ 4 *Policy Sciences* 155.

⁸ Under a model of centralized state power, ‘legislators’ might be parliamentarians and perhaps their official advisors, while under a model of dispersed state power ‘legislator’s might be all members of a community. The adoption of either model of democratic government does not affect the point that I am making here – that regulatory impact analysis offers the prospect of better informed public policy which emerges from a process which acknowledges and responds to moral disunity within a particular community.

⁹ Commonwealth of Australia, *A Tax System Redesigned*, Final Report of the Review of Business Taxation (Chair: John Ralph AO), Treasury, Canberra, 1999, 149ff.

¹⁰ Commonwealth of Australia, *Rethinking Regulation*, Report of the Taskforce on Reducing Regulatory Burdens on Business, Productivity Commission, Canberra, 2006, 113, 148ff.

¹¹ Australian Government, *Best Practice Regulation Handbook*, Productivity Commission, Canberra, 2006.

¹² Commonwealth of Australia, *Regulation and its Review 2005-06*, Productivity Commission, Canberra, 2006, ch 1.

being a success for public accountability in this era of public disillusion with public officials, the tax Regulation Impact Statements offer little in terms of facilitating credible, informed public appraisal of the legislative interventions by public officials. Behind the veneer of public accountability and bureaucratic rationality created by the RIS process, much legislation is developed and/or modified behind closed doors in order to procure the favour of particular interests. And even where such cynicism is not apparent, it is clear that much legislation is enacted after little or no critical analysis. To be effective both as a public policy tool and a means of engendering legitimacy, the scope of the taxation RIS process must be expanded significantly and they must be incorporated within a framework of ongoing scrutiny of the taxation system.

II DEMOCRATIC POLITICAL THEORY AND NORMATIVE GUIDELINES FOR PUBLIC POLICY MAKING

Within democratic political theory there is considerable debate regarding the nature and extent of general public participation in public policy making. Even a cursory review of the literature in this field indicates that 'democratic political theory' misrepresents what is, in truth, a plethora of political theories which span a broad spectrum.¹³ In the contemporary Australian political environment, identifying the function of RISs will depend upon which of two 'mainstream' concepts of democratic government is adopted:

1. A centralized concept of state power which focuses upon a policy elite comprising politicians, bureaucrats and other key 'stakeholders' such as business representatives. Under this centralist model, legislators are charged with the business of government and the general populace is remote from the everyday business of government. However, the legislative elite is accountable to the general electorate by virtue of 'open and fair' elections.¹⁴ Such elitist theories of government variously despair at the collusion between government and 'special interests'¹⁵ or quite possibly endorse such elitism as a normative model;¹⁶ and
2. the participatory¹⁷ and civic republican¹⁸ strands of democratic theory emphasize the importance of active, informed and ongoing engagement of the general public, or at least some sections of the public, in the political process. These models of democratic government, which acknowledge the dispersal of state power throughout a community, envisage government in terms of a partnership between state functionaries and 'the people'. The active engagement of all of 'the people' in every policy decision is impractical in this age of 'big government'. However, the civic republican and participatory models of democratic government at least present an

¹³ Dowdle (ed), above n 5, 3ff. For consideration of alternate models of democratic government see: David Held, *Models of Democracy*, Polity Press, Cambridge, 2006 (3rd edn).

¹⁴ For a critical review of the extent to which the general public is placed in a position to critically assess the performance of its legislators see: Ian Shapiro, *The State of Democratic Theory*, Princeton University Press, Princeton, NJ, 2003, ch 5.

¹⁵ Robert Dahl, *A Preface to Economic Theory*, Polity, Cambridge, 1985, 50.

¹⁶ J Schumpeter, *History of Economic Analysis*, Oxford University Press, New York, 1954. Schumpeter is somewhat ambivalent as to whether his elitist model is merely descriptive or whether it is normative.

¹⁷ Carole Pateman, *Participation and Democratic Theory*, Cambridge Uni Press, Cambridge, 1970.

¹⁸ Deliberative democracy may be founded upon a rationalist norm, as in: Claus Offe and U Preuss, 'Democratic Institutions and Moral Resources' in David Held (ed), *Political Theory Today*, Polity Press, Cambridge, 1991. Other deliberative democrats embrace a pluralist norm: Chantal Mouffe, 'Democracy and Pluralism: A Critique of the Rationalist Approach' (1995) 16 *Cardozo Law Review* 1533; see also James Tully, 'The unfreedom of the moderns in comparison to their ideals of constitutional democracy' (2002) 65 *Modern Law Review* 204, 217.

ideal framed in terms of lowering the barriers to active engagement in public policy for those wishing to participate.

Under the first model of government, RISs are an instrument by which the technocratic policy elite refines its legislative outputs. Those responsible for developing legislation must ensure that they seek and take account of information provided by those 'directly affected' by legislation. As this model has come to be understood in contemporary times, the category of 'those directly affected by legislation' is generally accepted to comprise business regulatees.¹⁹ One aspect of the emergence of neoliberal philosophy has been the ascendance of the view that the function of government is to promote the public interest which is understood in terms of the creation of a favourable environment for private investment.²⁰ Indeed, as already noted, the genesis of the RIS process can be traced to a 'pro business' backlash against what was perceived to be undue state intervention into the 'private' domain.²¹

Under this first model of democratic government the general public is acknowledged by way of afterthought:

In accordance with the principles set out above, the Taskforce considers that no regulation should be introduced unless the need for government action and the superiority of the preferred option have been transparently demonstrated. This is not asking too much. Business has a right to expect that governments will follow good process when making decisions that impact on it, as indeed does any section of the economy or society.²²

Here there is acknowledgment of the role of the RIS process in enhancing the capacity of the general public to hold public officials to account,²³ but such references to broad public participation are fleeting and there is no detailed consideration of the barriers to public participation in the policy making process and nor is consideration given to how the RIS process might serve to lower those barriers to participation.

Although the impetus for RISs has been framed in terms of enhancing democratic accountability, it is a thin concept of accountability which underpins the elitist model of democratic government. In this discourse, the mainstream concept of transparency is taken to entail a minimalist description of the nature of public policy decisions made by central government.²⁴ In particular, the concept of transparency is not taken to entail the provision of information to the general public so that it might actively engage in the policy making process and meaningfully hold elected officials to account come election day.

Under the second concept of democratic government, public confidence in the exercise of state power is engendered by promoting broad and informed public participation in the process of government.²⁵ Norms derived from the second model of democracy evidence less emphasis upon gaining information from the public and more emphasis upon fostering and enabling active engagement with the public at all stages of the policy cycle – from agenda setting to post implementation evaluation. Thus, both deliberative and participatory models of democracy call for the dissemination of 'accessible'²⁶ information to the general public such that the decisions of public officials can be subjected to informed, critical scrutiny. Thus, the

¹⁹ For consideration of this point see section 3(i) below.

²⁰ Charles E Lindblom, *Politics and Markets*, Basic Books, New York, 1977, 122-3.

²¹ Thomas O McGarity, *Reinventing rationality: The Role of Regulatory analysis in the federal bureaucracy*, Cambridge Uni Press, Cambridge, 1991, ch 2.

²² Government of Australia, above n 11.

²³ OECD, *Background Document on Regulatory Reform in OECD Countries*, OECD, Paris, ND, 26.

²⁴ Mark Burton 'Is Participatory Tax Transparency Achievable?' (2006) 4(3) *Tax Notes International* 333-357.

²⁵ OECD, *Citizens as Partners*, OECD, Paris, 2001.

²⁶ Pauline Poland, *Online Consultation in GOL-IN Countries – Initiatives to Foster e-democracy*, A joint project of the Government On-line International Network, 2001.

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; and
6. Governments should adopt measures which build the capacity of citizens to actively engage in the process of shaping public policy.²⁷

Other examples of policies which promote active engagement in public policy formation on the part of the citizenry have also been adopted.²⁸ The broad proposition which emerges from these normative statements is that public policy formation is no longer generally conceived in terms of a top-down, hierarchical or inside-out manner. The emphasis given to inclusive consultation indicates that something more is envisaged – the active engagement of the citizenry in the formation, implementation and review of public policy. Of course, such democratic processes do not entail abdication from public accountability on the part of those charged with government – governors remain ultimately responsible for the legislative outcomes.

Under this model, the development and publication of an RIS would be an integral aspect of active engagement with the general community rather than specifically identified ‘stakeholders’.²⁹ Thus, under this model, the development of an RIS would include:

1. Community consultation upon agenda setting with a view to identifying the most pressing regulatory issues;
2. publication of a ‘green’ paper with respect to each high priority issue, outlining the nature of the perceived problem, providing a preliminary statement of relevant information known to government (and lacunae in that information), an outline of alternate courses of action and a statement of reasons for adopting the preferred course of action. Publication of such a green paper would be accompanied by an open invitation to make submissions to government and the provision of adequate time for such submissions to be made;
3. a process of open consultation with the general community, which allows adequate time for the information provided in the green paper to be disseminated and considered;
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

²⁷ OECD, *Citizens as Partners*, OECD, Paris, 15.

²⁸ See, for example, European Commission, *The Commission’s contribution to the period of reflection and beyond: Plan-D for Democracy, Dialogue and Debate*, COM(2005) 494 final, Brussels, 2005; European Commission, *European Governance: White Paper*, COM(2001) 428 final, Brussels, 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, Brussels, 2002.

²⁹ Enhancing access to information is one response to the public choice critique of democratic government. By lowering barriers to participation in the public policy ‘market’, participation in that market is not reserved for well resourced interest groups and, further, legislative favours purchased from corrupt/morally bankrupt politicians are liable to be exposed to public scrutiny.

- legislation as well as the effectiveness of the legislation in achieving the stated policy;
and
5. the entire legislative process, including preparation of the RIS, being subject to evaluation.

The preceding discussion of the significance of democratic political theory to the framing of an RIS process might be taken to suggest that the two models are mutually exclusive, but it is possible to construct a policy making model which incorporates elements of both models. Thus, the literature which largely adopts the first model does make fleeting reference to the pluralist policy making envisaged in the second category of policy making models.

III WHAT MODEL OF DEMOCRATIC ACCOUNTABILITY IS REFLECTED IN THE AUSTRALIAN TAXATION RIS PROCESS?

A The Genesis of Regulation Impact Statements in Australia

The origins of Regulation Impact Statements in Australia have been considered elsewhere.³⁰ Suffice to say that the impetus for Australian Regulation Impact Statements can be traced to the second wave of deregulatory fervour which swept the 'developed' world from the early 1980's. After the first rush of cutting regulation by repealing specific regulatory instruments, the process of creating legislation came to be conceived in terms of the hard science of economic analysis. On the assumption that all legislative costs and benefits could be measured, the cost/benefit statement was taken to be the basis for assessing the merits of proposed and existing legislation.

By the early 1990's the first traces of this outlook upon the legislative process could be discerned.³¹ However, the explicit adoption of Regulation Impact Statements in Australia originated from the Prime Minister's response³² to the report of the Small Business Deregulation Task Force.³³ The focus of this report and the Prime Minister's response was upon reducing the cost of regulation upon business. This emphasis has been retained, and now is reflected in the location of the Office of Best Practice Regulation within the Productivity Commission (rather than, for example, the Attorney-General's Department), the focus of the Commonwealth government's taskforce regarding the regulatory burden upon *business*³⁴ and the revised RIS requirements which incorporate a *business* compliance cost calculator.³⁵

In a sense this concentration upon the perceived plight of business at the hands of what is portrayed as an unaccountable and rampant bureaucracy is understandable. Certainly, it is true to say that the focus of the centralist model has been upon the second generation of deregulatory reform with the purpose of reducing the regulatory cost imposed upon

³⁰ Michael d'Ascenzo 'Regulation Impact Statements and compliance costs: an Australian perspective' in Chris Evans, Jeff Pope and John Hasseldine, *Tax Compliance Costs: A Festschrift for Cedric Sandford*, Prospect, Sydney, 2001, 353.

³¹ For the original proposal regarding the introduction of regulation impact statements see: Commonwealth of Australia, *An Assessment of Tax*, Report 326 of the Joint Committee of Public Accounts, AGPS, Canberra, 1993, 91. For an overview of the ATO practice with respect to Regulation Impact Statements see: D'Ascenzo, above n 30. For a comparative review of legislative practice with respect to regulation impact statements see: Chris Evans and Michael Walpole, *Compliance Cost Control: A Review of Tax Impact Statements in the OECD*, ATRF, Sydney, 1999.

³² The Hon John Howard MP, *More Time for Business*, 24 March 1997, Canberra.

³³ Commonwealth of Australia, *Rethinking Regulation*, Report of the Taskforce on Reducing Regulatory Burdens on Business (Gary Banks, Chair), Productivity Commission, Canberra, 2006

³⁴ John Howard, *Taskforce on Reducing the Regulatory Burden on Business*, Canberra, 12 October 2005.

³⁵ Commonwealth of Australia, above n 33, Appendix E.

businesses.³⁶ Thus, for example, the recent Australian Taskforce on Reducing Regulatory Burdens on Business³⁷ created the backdrop for review of the Australian RIS process – the emphasis upon consultation with business rather than the community at large represents the overt assumption that the ‘business’ interest in good regulatory practice is superior to the interest of the general community.

B Australian criteria for ‘adequate’ Regulation Impact Statements

The nature of RISs is set out in the *Best Practice Regulation Handbook* (the Handbook),³⁸ which states that an RIS has seven key elements:

1. Identification of the problem or issue which gives rise to the need for action;
2. The desired objectives;
3. The options (regulatory/non-regulatory) that may constitute viable means for achieving the desired objective;
4. An impact analysis, comprising an assessment of the impact (costs and benefits) on consumers, business, government and the community of each option;
5. A consultation statement, which must detail:
 - a. the consultation objective
 - b. how consultation was conducted;
 - c. the views of all of those consulted, including dissenting views;
 - d. how the various views were taken into account; and
 - e. if full consultation was not undertaken, provide a reasonable explanation for this omission
6. A recommended option; and
7. A strategy to implement and review the preferred option.³⁹

It is significant that these indicia of an acceptable RIS do not include reference to consultation upon agenda setting, to provision of information to the general public with a view to promoting active and informed public participation in the policy process and nor do they include reference to evaluation of the policy making process itself. As such, the Australian interpretation of ‘best practice’ may be something of a misnomer when a comparison is drawn to the practice adopted in other OECD countries such as the United Kingdom. No explanation is given for why the normative framework adopted in other countries has not been adopted in Australia. The Australian RIS framework with respect to general legislation is, then, a second best paradigm.

Nevertheless, Chapter 4 of the *Best Practice Regulation Handbook* explains in considerable detail the substantial research effort which must be undertaken in justifying regulatory intervention in the particular policy domain. Inevitably, in undertaking the gargantuan empirical and qualitative task which this aspiration entails, satisficing⁴⁰ and heuristics⁴¹ will constitute the ultimate foundation for the selection of the desired policy response.⁴² Rather

³⁶ See, for example, OECD, *The OECD Report on Regulatory Reform: Synthesis*, OECD, Paris, 1997, 5ff.

³⁷ Commonwealth of Australia, above n 33.

³⁸ Commonwealth of Australia, above n 11.

³⁹ Id, 3-4 to 3-5.

⁴⁰ Herbert Simon, ‘A Behavioral Model of Rational Choice’ (1955) 69 *Q J Econ* 99.

⁴¹ For a discussion of the relevant literature see: Edward L Rubin, ‘Public Choice, Phenomenology, and the Meaning of the Modern State: Keep the Bathwater, But Throw out the Baby’ (2002) 87 *Cornell L Rev* 309, 315-6.

⁴² McGarity, above n 19.

than Weber's steel hard cage of bureaucratic rationality,⁴³ bureaucratic action is ultimately founded upon the soft science of intuition. There will inevitably be limits to the capacity of bureaucrats to fulfil this task. The Handbook therefore might best be understood as expressing an aspiration to bureaucratic rationality. Notwithstanding the subjective element within the RIS process, the aspiration to rational bureaucratic decision making expressed in this best practice regulation guide means that public policy makers must remain open to alternate viewpoints and engage with those viewpoints when raised. It remains to be seen whether this aspiration to bureaucratic rationality is carried into effect.

However, such an inquiry need never trouble those interested in the tax policy process because the *Best Practice Guide* substitutes significantly less onerous RIS requirements with respect to taxation legislation. According to the Guide, an RIS with respect to taxation legislation need only provide the following information:

1. Specification of the policy objective;
2. Identification of the implementation options with respect to achieving the stated policy objective;
3. Assessment of impacts of the various implementation options; and
4. Statement of preferred option.⁴⁴

As a result, the *Best Practice Guide* accepts what can only be described as a third best normative framework with respect to the development of Australian tax regulation. According to the *Best Practice Guide*, there is no need for an RIS to provide a critical review of the evidence justifying the particular policy measure. This exclusion therefore restricts the taxation RIS process to an appraisal of means to achieve a given government policy objective, rather than an appraisal of alternate policy ends. The effect of this exclusion is to suppress the development of views at odds with government policy and also to suppress the gathering of information which might call government policy into question. Without the benefit of such information, which might enable the identification of (possibly better) policy paths not taken, it is extremely difficult for the general public to hold a government to account for its policy choices. For example, the entrepreneurs' tax offset was developed in the Prime Minister's office during a federal election campaign,⁴⁵ no doubt with the object of shoring up support from the crucial small business lobby, support which was forthcoming after the measure was announced. At a cost of \$400 million per annum, this expensive program was not subjected to any rigorous review to determine whether this substantial investment was truly in the public interest.

It is also clear from the *Best Practice Guide* that consultation upon the merits of the government's measure is not mandatory, as the Guide observes that consultation will often be inappropriate, adding that 'consultation may have occurred during the drafting of tax legislation required to give effect to the Government's decision.'⁴⁶ The limited nature of any consultation which may occur is also indicated by the Treasury policy with respect to consultation, which holds that consultation is primarily a fact gathering exercise on the part of government, rather than a dialogue:

The aim of consultation is to gather information about the practical operation of the taxation system and improve the quality and effectiveness of changes to the system that the Government proposes. The community consultation process provides you, or your organization, as a stakeholder in the tax system, with an opportunity to express your views on

⁴³ Max Weber, 'Politics as a Vocation,' in H.H. Gerth and C.W. Mills (eds), *From Max Weber*, Oxford University Press, New York, 1972, 79.

⁴⁴ Commonwealth of Australia, above n 11, 5.4ff.

⁴⁵ Liberal Party of Australia, *Promoting an Enterprise Culture*, Melbourne, 26 September 2004.

⁴⁶ Commonwealth of Australia, above n 11, 5-7.

how proposed changes to the tax system will affect you. Consultation also encourages understanding of the range of stakeholder views. The community consultation process allows the Government to benefit from your practical experience, skills and knowledge and incorporate this into the tax design process.⁴⁷

This limited approach to community consultation appears inconsistent with many of the recommendations of the Board of Taxation, in particular:

1. That the government make a commitment to consult on the development of all substantive tax legislation initiatives, except in exceptional circumstances only;⁴⁸
2. That a consultation framework include input from external stakeholders, from agenda setting to finalization of the policy change;⁴⁹
3. That there be ongoing evaluation of consultation measures;⁵⁰ and
4. That adequate feedback be provided to external stakeholders who participate in the consultation process.⁵¹

Curiously, the only official justification⁵² for rejecting such recommendations in favour of the current practice is found in the *Best Practice Guide*, rather than in the Treasury statement regarding consultation. The *Best Practice Guide* indicates that the circumscribed practice of tax regulation development is warranted because:

1. Prior public consultation on taxation measures could release sensitive information regarding tax avoidance, which might be exploited until remedial legislation (if any) took effect;
2. Taxation measures may be announced in the annual Budget papers or in Ministerial statements, and prior public consultation upon such measures would jeopardize the integrity of the budget process or ‘inhibit the usefulness of such Ministerial statements’;
3. The incidence of a tax measure may be difficult to establish, and this may ‘place constraints on the public consultation process’; and
4. Review processes for taxation measures are already in place.⁵³

These issues do not represent an insurmountable barrier to broad public participation in tax system design, as discussed in the following paragraphs.

1. Responding to tax avoidance

The release of information regarding tax avoidance schemes as part of open consultation upon remedial measures might affect the Government revenue if remedial legislation is introduced with prospective effect – between the time consultation commences and the start date for the remedial legislation many more may exploit the tax minimization opportunity. This justification for denying open consultation upon measures to counteract tax avoidance is predicated upon the assumption that remedial legislation can only take effect prospectively, rather than taking effect from the time open consultation commences.

In general it is accepted that legislation should be introduced with prospective effect – that legislation should only take effect from the time that a proposed measure becomes law. The principle of prospectivity is founded upon the rule of law discourse which holds that it is

⁴⁷ The Treasury, *Engaging in Consultation on Tax Design*, Canberra, 2003, 2.

⁴⁸ Commonwealth of Australia, *Government Consultation with the Community on the Development of Taxation Legislation*, Board of Taxation, Canberra, 2002, 7.

⁴⁹ Id, 9.

⁵⁰ Id, 17.

⁵¹ Id, 17.

⁵² Although note the observations of the Board of Taxation: Commonwealth of Australia, above n 48, 7-8.

⁵³ Commonwealth of Australia, above n 11, 5-1.

inappropriate for law to be applied retrospectively. This principle of prospectivity, in turn, is a tenet of liberal legalism which maintains that a person should be able to plan their future activities with full knowledge of the law as currently in force – retrospectivity therefore breaches this principle.

However, the prospectivity principle is not absolute and, in fact, in taxation matters the Australian government routinely departs from the principle. In the past taxation policy has been announced and any resulting legislation took effect retrospectively, from the time at which the consultation phase was publicly announced.⁵⁴ There have also been cases where measures have been announced but not implemented.⁵⁵ Alternatively, as was the case with respect to legislation emanating from the Review of Business Taxation, some legislation was backdated to the date that tax minimization arrangements were publicized.⁵⁶ Once it is seen that the Australian government has not adhered to the prospectivity principle by applying remedial legislation retrospectively, it can be argued that there is little reason not to extend the period of retrospective operation to the commencement of open consultation upon remedial legislation. In this way, the government might signal to private markets its concern regarding particular tax schemes, engage in open consultation and protect its revenue. The retrospective impact of such remedial measures would be moderated by the fact that private markets were fully informed of anticipated government action.

Protection of government revenue is therefore not necessarily inconsistent with engaging in open consultation upon tax reform.

2. *Preserving the integrity of the Budget process and preserving the ‘usefulness’ of Ministerial announcements*

This rationalization of elitist tax policy design assumes that Budget announcements and Ministerial press releases should include ‘new’ policy material and this need not necessarily be the case. In fact, once again, in the past the Australian government has routinely made tax policy announcements outside of the Budget process.⁵⁷ Moreover, many such Ministerial announcements have heralded the commencement of a consultation process rather than constituting the announcement of final government policy.⁵⁸

Budget announcements could comprise a statement regarding the fiscal impact of altered tax policy which has been determined at the end of a process of consultation. Alternatively, Budget announcements might signal the existence of an issue requiring policy adjustment and commence the process of consultation. Similarly, Ministerial announcements might signal the commencement of government consultation with respect to a particular issue.

The suggestion that Budget integrity and the usefulness of Ministerial announcements somehow justifies elitist policy making is therefore misplaced. Rather, this rationalisation seems to be more about maintaining the fanfare of the Budget than developing sound public

⁵⁴ Thus, for example, the original capital gains rules were preceded by a policy announcement on 19 September 1985, with legislation being passed into law in June 1986 and a commencement date of 20 September 1985.

⁵⁵ As was the case with entity taxation – see Brett Freudenberg, ‘Entity Taxation: The Inconsistency between Stated Policy and Actual Application’ (2005) 1 *Journal of the Australasian Tax Teachers Association* 458.

⁵⁶ See, for example, the loss duplication rules: Peter Costello MP, *The New Business Tax System*, Media Release 058, 21 September 1999, Attachment Q ‘Reinforcing Tax System Integrity: Preventing Loss Duplication and Value Shifting’; see also Subdivision 165-CA, *Income Tax Assessment Act 1997* (Cth).

⁵⁷ Perhaps the most significant was the Government’s response to the Review of Business Taxation, announced on 21 September 1999: see Peter Costello, *Review of Business Taxation*, Media Release 56/1999, Canberra, 1999.

⁵⁸ Brett Freudenberg, ‘Entity Taxation: The Inconsistency between Stated Policy and Actual Application’ (2005) 1 *Journal of the Australasian Tax Teachers Association* 458.

policy.⁵⁹ It may also be motivated by the Treasurer's desire to maintain control of the media message emerging from the Budget by selectively leaking budget information to favoured journalists which thereby sustains the integrity of 'the drip.'⁶⁰

There is no credible reason why public consultation upon tax reform might not be undertaken well in advance of an announcement of the outcome of that consultation during the budget.

3. *Difficulty in ascertaining the incidence of tax measures*

This rationalization is predicated upon the view that only those directly affected by proposed legislation ought be consulted, and that consultation will only be undertaken where those directly affected can be identified before the proposed measure takes effect.

However, again, the assumption underlying this proposition is not absolute. It is not necessarily the case that government should only consult with those directly affected by legislation. Those 'indirectly' affected by taxation measures, for example those who will shoulder a greater proportion of the overall tax burden as a result of the grant of a tax expenditure, might validly claim that they are also directly affected by such a measure. After all, they pay more tax than they otherwise would need to pay. Further, if it is truly the community's taxation system, as the Commissioner of Taxation often states in his efforts to promote voluntary compliance,⁶¹ surely the general community has an interest in being heard as to how those tax laws should be framed.

Even if it is accepted that those 'directly affected' by a proposed measure have a special right to be heard and that it may be difficult to identify this class of taxpayers, this is hardly a reason to exclude consultation with the broader community. Indeed, it is more a reason to consult with the broader community in order to allow the unidentified stakeholders to come forward and advise the government as to how the proposed measure would impact upon them specifically.

4. *There are review mechanisms already in place*

Unfortunately, the review mechanisms referred to are not detailed in the Handbook and so one is left to speculate as to what they are. It is most probable that the Handbook is referring to review of taxation policy by government departments including the Australian Treasury, Prime Minister and Cabinet and the Australian Taxation Office.

Review by government departments is not transparent. It seems that the Commissioner of Taxation restricts himself to advising government when he considers that the law is not achieving its policy intent,⁶² notwithstanding that the policy intent of much legislation can be elusive.⁶³ Moreover, the content of this advice is not made public – the Commissioner restricts himself to providing aggregated data regarding the number of such advices to government each year.⁶⁴ This means that the task of scrutiny of the merits of legislation falls

⁵⁹ Allan Maslove, Michael Prince and G Bruce Doern, *Federal and Provincial Budgeting*, Uni of Toronto Press, Toronto, 1985, ch 2.

⁶⁰ Australian Press Council, (1994) 6 *Australian Press Council News* 1; Max Suich, 'Mark Latham's Bad Media Day', *The Age*, 21 January 2005, 17.

⁶¹ See, for example: Michael D'Ascenzo, 'It is the Community's Tax System', Speech delivered at the 18th Australasian Tax Teachers Association Conference, University of Melbourne, 30 January 2006.

⁶² Commonwealth of Australia, *Commissioner of Taxation Annual Report 2005-06*, Australian Taxation Office, Canberra, 2006, 27.

⁶³ See, for example: Commonwealth of Australia, *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*, The Board of Taxation, Canberra, 2005, 4.

⁶⁴ Commonwealth of Australia, *Commissioner of Taxation Annual Report 2005-06*, Australian Taxation Office, Canberra, 2006, 27.

to the Australian Treasury. Unfortunately, it is not possible to determine whether such scrutiny takes place, how rigorous any such scrutiny is and what action is taken in response to any such reviews. The extent of Treasury secrecy,⁶⁵ and the stated position of the current Secretary of the Treasury to the effect that he is not prepared to allow Freedom of Information requests to be used to embarrass the government,⁶⁶ means that there is little prospect that the general public can call politicians to account. There is an absence of credible research, grounded upon data which only government has access to because of the Commissioner's secrecy obligations,⁶⁷ which critically assesses what might be a rosy depiction of legislative success published by Ministers and their media advisors.

Reviews undertaken by the Board of Taxation and also government-initiated reviews such as the Review of Business Taxation are ad hoc, partial and subject to political interference. These mechanisms are no substitute for a systematic process of open public review of all taxation legislation, and active consultation with the general public at all stages of the policy cycle.

The preceding review of the Australian taxation RIS process suggests that accepted norms for best practice regulation are not incorporated into the Australian taxation RIS process. Indeed, while the Australian requirements with respect to Regulation Impact Statements for non-taxation legislation were recently made more stringent,⁶⁸ a comparison of the requirements for taxation Regulation Impact Statements indicates that little has changed with respect to critical appraisal of the merits of proposed legislation. Moreover, when one reviews the reasons proffered as justification for the Australian approach, it seems that those reasons have more to do with stifling dissenting views upon the merits of the government's tax policy rather than the development of meritorious tax policy.

D The failure of the current RIS process

1 The Government's glowing appraisal of the RIS process for taxation legislation

As previously noted, the *Best Practice Regulation Handbook* accepts that there is no need for an RIS to provide a critical review of the evidence justifying the particular policy measure. It is therefore unsurprising that such a low threshold for critical scrutiny of taxation legislation is easily met. In 2006 the Office of Regulation Review reported that 92% of RIS's prepared with respect to new tax 'regulations' were assessed as 'adequate' at the decision stage while 100% were assessed as adequate at the tabling stage.⁶⁹

2 Examples of the defective Australian taxation RIS process

Despite such positive performance reports, the recent history with respect to the provision of tax concessions is a sorry tale of publicly funded largesse provided upon the basis of vague claims regarding the merits of the particular concessions.⁷⁰ Thus, for example, small business tax concessions such as the entrepreneurs' tax offset⁷¹ are justified upon the basis that micro

⁶⁵ For discussion of which see: Mark Burton, 'Chaos, Rhetoric and the Legitimation of 'Democratic' Government: A Critical Review of the Australian Tax Legislative Process', Paper presented at REGNET Seminar, 10 April 2007.

⁶⁶ The Canberra Times, 'Riding Treasury's Roller coaster', *The Canberra Times*, 23 January 2006, 11

⁶⁷ See *Income Tax Assessment Act 1936* (Cth) s 16.

⁶⁸ See Commonwealth of Australia, above 11.

⁶⁹ Commonwealth of Australia, *Regulation and its Review 2005-06*, Productivity Commission, Melbourne, 2006, 40.

⁷⁰ Mark Burton, 'Small business tax advantages: towards holism with a suggested definition, typology and critical review' (2006) 4 *Journal of the Australasian Tax Teachers Association* 78-106.

⁷¹ *Income Tax Assessment Act 1997* (Cth) Subdivision 61-J.

businesses need assistance, although the case for this is not substantiated by reference to any data.

The entrepreneurs' tax offset was developed from within the Prime Minister's office in the midst of the 2004 federal election campaign – neither the personnel nor the time for the considered development of tax policy. In his policy statement, *Promoting an Enterprise Culture*,⁷² the Prime Minister announced that tax incentives would be introduced to promote the development of an 'entrepreneurial spirit' in Australia.⁷³ Such vague statements might be understandable in the context of an election campaign where politicians might wish to present a small target to their political foes, however the RIS accompanying the entrepreneurs offset legislation did nothing to refine the policy objective of this measure. Paragraph 1.41 of the Explanatory Memorandum states:

The objectives of this measure are to provide encouragement for enterprising Australians in the early days of their business, in particular to provide a greater benefit to businesses with greater productivity, and to provide incentives for the growth of small business especially the very small, micro and home-based businesses which are in the STS.⁷⁴

This statement of policy inaccurately represents the nature of the legislation in several ways:

- 1) Given that the availability of the offset is not limited according to the age of the enterprise, the measure clearly does not target small businesses in the startup phase. It is quite possible that a longstanding 'lifestyle business' will continue to obtain the benefit of the offset for many years, as the 'entrepreneur' may deliberately maintain a micro business for personal reasons such as maintaining a particular work/recreation balance. The public benefit from providing a tax concession to such 'entrepreneurs' is unclear;
- 2) Nor is it made clear just how the measure favours 'more productive' businesses. The combination of a turnover threshold with the fact that the offset only benefits those with taxable business profits means that the benefit of the offset will vary. But this variance is not necessarily tied to productivity. A micro business with a turnover of goods worth \$70,000 and a profit margin of just 10% will benefit little, while a service provider with the same turnover and minimal costs will obtain a substantial tax benefit. Superficially, the service provider is more productive because they have a greater profit, but this does not take account of the resources expended in generating that profit. If the service provider has to work 2000 hours per year (ie \$35 per hour) to generate that profit while the goods provider just works 100 hours per year (ie \$70 per hour), the goods provider might be considered to be more productive;
- 3) It is not clear that the offset will provide incentives for the growth of small business:
 - a) The Laffer curve suggests that a reduction in taxation rates is one factor which can reasonably be expected to affect investment choices (and particularly the work/leisure choice). However, there is a substantial body of literature that indicates that there is no clear correlation between the two variables. People may choose to work more for all sorts of reasons, including the fact that they do not necessarily see that work and leisure are dichotomous. It is possible that a reduction in tax rates will induce people to work more, but it is equally possible that people will work less as a result of the tax reduction because the tax reduction means that they can afford the same lifestyle while working less;
 - b) Moreover, the low turnover threshold means that many dynamic, expanding businesses will rapidly exceed the upper turnover threshold and therefore cease to

⁷² Above n 45.

⁷³ Id, 4.

⁷⁴ Explanatory Memorandum accompanying *Tax Laws Amendment (2004 Measures No. 7) Act 2005*.

qualify for the offset. For such businesses, the tax reduction afforded by the offset will be transient and hence limited. Incentives for growth are therefore more likely to be found from other sources such as competitive drive and the quest for greater profits to fund consumption/savings;

- 4) The low *turnover* threshold of just \$50,000, at which point the benefit of the offset begins to phase out, means that some ‘micro’ businesses will benefit while others will not, and it is not clear from the threshold criteria that those disqualified are not ‘enterprising’; and
- 5) The offset discriminates against full time micro business entrepreneurs as opposed to part time micro-business entrepreneurs. It is not clear why a person with taxable income of \$1 million derived from other sources should qualify for the entrepreneurs offset, while a person with a turnover of \$80,000 and total taxable income of \$20,000 should not benefit from this measure. Moreover, it is not clear why the first taxpayer with a high taxable income should obtain a greater cash benefit than a full time ‘entrepreneur’ with a low taxable income.

The absence of any credible review of the merits of the entrepreneurs’ tax offset means that this measure is not achieving the object for which it was purportedly introduced. Had such a review been undertaken, the \$400 million annual cost of this program may have been better targeted.

E Implications of the defective Australian RIS process

1 The quality of legislative outcomes

The construction of legislative policy behind closed doors and with apparently little or no effort to demonstrate how the expenditure of \$400 million procures the public benefit, as was the case with the entrepreneurs’ tax offset, is unlikely to be trumpeted as the paragon of legislative practice. The failure to establish the nature of the mischief to be remedied, the identification of alternate mechanisms for addressing that mischief and the selection of the most appropriate mechanism – usual steps in the construction of an RIS – meant that the vagaries and anomalies of the original policy were compounded in the drafting of the legislation itself.

Moreover, the failure to provide a critical assessment of the merits of the entrepreneurs’ offset in the accompanying RIS meant that the parliamentary oversight of this measure was severely limited. Although the Senate Economics Committee briefly discussed the targeting limitations of the legislation, its criticism was faint and it nevertheless concluded its report with an unreserved endorsement of the proposed measure.⁷⁵ Rather than calling the government to account and demanding evidence that this \$400 million per annum expenditure would be in the public interest, the Senate Economics Committee appears to have accepted the absence of credible information.

The development of legislation is doubtless a difficult task, and certainly far more complex than the idealized version of cost/benefit analysis would suggest. Crystallising the definition of the perceived issue to be addressed, identifying behavioural affects, grappling with linguistic imprecision, integrating new legislation into the extant legislative framework, accommodating the often competing claims of rival interests who often adopt different substantive standpoints are all matters which import considerable flexibility into the legislative process. However, while it might be accepted that Kantian rationalism is an unattainable rationalism, it is nevertheless true to say that this does not mean that any

⁷⁵ Commonwealth of Australia, *Provisions of the Taxation Laws Amendment (Measures No 7) Bill 2004*, Report of the Economics Legislation Committee, Parliament House, Canberra, 2005, 9.

legislative process is as good as any other. A sound RIS with respect to the entrepreneurs' offset would have identified the limitations of existing information, acknowledged the criticisms of the offset outline in section 4 of this paper and responded to those criticisms in justifying the elements of the offset. Moreover, the RIS would have identified performance measures against which the success of the offset could be measured by a post-implementation review.

The limited RIS accompanying the entrepreneurs' offset did none of these things, and thereby played a part in diminishing the quality of scrutiny of this measure.

2 *Legislative bias – concentration upon business compliance costs*

In section 2 of this paper it was noted that the RIS process arose from the emergent neoliberal critique of unrepresentative bureaucrats making and interpreting regulation without, it was said, paying due regard to the adverse impacts upon businesses.

The predominance of business interests in constructing the discursive realm in which the seeds of RISs grew is discernible in the contemporary Australian approach to RISs. The absence of appraisal of proposed tax measures on their merits, and the emphasis upon the 'compliance cost calculator' in the limited tax RIS process, mean that the process by which tax legislation is created favours business interests in myriad ways. For example, the influence of well-resourced business stakeholders who wield substantial influence 'behind closed doors' is enhanced if they are able to broker legislative deals which will not be subjected to credible, independent scrutiny by a well resourced professional government which adequately represents the 'public interest' (in the sense of reviewing the proposed measure from alternate perspectives). The emphasis upon calculating compliance costs, without paying due recognition to managerial benefits which might arise from implementation of a proposed regulation, also serves to skew the consideration of alternate regulatory measures.

3 *Accountability, Legitimacy and Voluntary Compliance*

The concept of accountability entails calling public officials to account for their decisions. The intersection of the concept of accountability, legitimacy and contemporary democratic theory has generated a concentration upon procedural legitimacy.⁷⁶ Under this model of procedural legitimacy, the general public is unable to understand the complexity of the modern policy environment. Accordingly, the general public purportedly uses the credibility of the process of government as a proxy for the substantive content of government policy.⁷⁷ If the process withstands scrutiny, the general public accepts that the substantive content of government policy must also be acceptable and will therefore accept the government's rule as legitimate.

Measured against the norm of procedural accountability, it is doubtful that the development of Australian taxation legislation is satisfactory. The departure from the norm of accountable government which is evident in the norms applied to RISs for other Australian legislation, and also the weakness of the rationalization for this departure, mean that the legitimacy of the Australian taxation system is open to threat. The limitations of the taxation RIS process mean that the general public cannot assess the substantive legitimacy of particular taxation measures and/or of the Australian taxation system overall. Further, these limitations mean that the Australian public cannot be assured that government has procedures in place to assess the substantive merits of its taxation system. Thus, the general public is not in a position to assess the substantive or the procedural legitimacy of the taxation system.

⁷⁶ Tyler,

⁷⁷ Id

The Centre for Tax System Integrity survey data indicated that there is considerable public skepticism regarding the extent to which the current tax system reflects the public interest, as opposed to the interests of those able to wield substantial influence amongst legislators and bureaucrats.⁷⁸ This suggests that a significant proportion of the Australian public questions the legitimacy of the Australian tax system. However, the practical significance of this finding is open to question.⁷⁹ It may be that the Australian public considers the tax system to be illegitimate and therefore does its utmost to minimize its tax contribution. Or it may be that the Australian public ignores this skepticism and is influenced by other factors, such as the perceived legitimacy of the Australian Taxation Office, in choosing to voluntarily comply with the law. Establishing a correlation between perceptions of substantive legitimacy/procedural legitimacy and actual voluntary compliance is therefore difficult. However, if such a correlation exists, an RIS process which adopted the norms outlined in section 2 above would enhance the legitimacy of Australian tax legislation and thereby promote voluntary compliance.

4 *Interpretative theory, purposive interpretation and principles based drafting*

Adoption of a broader tax RIS process which incorporates a thorough exposition and critique of the underlying legislative policy would generate a clearer enunciation and explanation of the legislative purpose. According to contemporary regulatory theory, this clearer enunciation of the legislative purpose would reduce the costs of administering the taxation law.⁸⁰ The Australian Government endorses principles based drafting of tax legislation wherever possible with a view to promoting tax simplicity.⁸¹ However, this objective is undermined by the omission of a comprehensive RIS process with respect to tax legislation. Perhaps fortunately, the legislative draftsman did not hazard a guess at the principle underlying the entrepreneurs tax offset, given the vague statement of purpose in the RIS such a statement would have been uninformative to those interpreting the legislation.

5 *The inefficacy of post implementation review*

The limitations of the Australian taxation RIS process also impede the conduct of credible post implementation reviews by the Board of Taxation. Ideally, in justifying a particular regulatory measure, an RIS would identify appropriate performance measures against which the legislation might be assessed in a post implementation review. The limited Australian tax RIS does not provide this information.

Moreover, 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,'⁸² in a quite limited fashion. Rather than taking the opportunity to conduct a broad 'tax expenditure analysis' akin to that envisaged by Surrey,⁸³ the Board restricts the scope of its post implementation reviews by merely examining the technocratic aspects of legislation, being the extent to which the legislation:

- 1) Gives effect to the government's policy intent;

⁷⁸ Valerie Braithwaite, *Perceptions of Who's Not Paying Their Fair Share*, Working Paper No 54, Centre for Tax System Integrity, Canberra, 2004

⁷⁹ Valerie Braithwaite (ed), *Taxing Democracy*, Ashgate Publishing, Ashenden, 2003, 17, citing M Fishbein and I Ajzen, 'Attitudes Toward Objects as Predictors of Single and Multiple Behavioural Criteria' (1974) 81 *Psychological Review* 59; S Epstein, 'Aggregation and Beyond: Some Basic Issues on the Prediction of Behavior' (1983) 51 *Journal of Personality* 360.

⁸⁰ Commonwealth, above n 10, 109.

⁸¹ Id.

⁸² <http://www.taxboard.gov.au/content/charter.asp>

⁸³ Stanley Surrey, *Pathways to Tax Reform*, 1973

- 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.⁸⁴

IV CONCLUSION – WHY THE AUSTRALIAN RIS PROCESS HAS GONE AWRY AND WHAT IS TO BE DONE

There are two primary causes of the dysfunctional Australian tax RIS process. The first is the culture of government secrecy sustained by the Australian Treasury and the Treasurer. The second is the preeminence given to business compliance costs in the genesis, development and implementation of the RIS process.

The Australian Treasury perceives its role as confidential advisor to government⁸⁵ and therefore it is understandable that those who adhere to this elitist vision of democratic government would submit themselves to the government's strategic interest of not facilitating open and informed scrutiny of government taxation policy. At every turn the Australian Treasury seems to do what it can to limit the flow of information which may call the Government's tax policy into question – the current Secretary of the Treasury is reported to have commented that it is not his role to help people embarrass the government by releasing damaging Treasury documents under Freedom of Information laws.⁸⁶ It is therefore understandable that taxation regulation is singled out for generous exclusions from the more rigorous RIS process that applies to Commonwealth regulation more generally. Unless this culture of bureaucratic secrecy can be changed, it is unlikely that the taxation RIS process will be broadened to include a credible, critical, open review of the merits of proposed regulation.

The limitations of the RIS process are also a product of the institutional history of the RIS process. The neoliberal backlash against the regulatory state promoted the perception of the crushing burden of state regulation orchestrated by unrepresentative bureaucrats.⁸⁷ This pathogen, it was argued, could be eliminated by careful cost benefit analysis and consultation with those 'directly affected' by regulation (ie businesses).⁸⁸ This focus upon minimizing business compliance costs has served to limit the usefulness of regulation impact statements in terms of enhancing the quality of public policy because other considerations, such as the equity of the proposed taxation measure, are ignored. Moreover, the concentration upon those directly affected in terms of the business compliance costs of proposed regulations has meant that the RIS process has never been closely allied with the discourse of enhancing democratic participation and government accountability to the general populace. Decoupling the RIS process from this concentration upon business compliance costs and connecting it with the discourses of legislative legitimacy and broad, active and informed public participation in policy making would substantially enhance the value of the RIS process to the Commonwealth.

⁸⁴ See, for example: Commonwealth of Australia, *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*, The Board of Taxation, Canberra, 2005.

⁸⁵ Australian Government, *T-Notes: Some Information on Feedback*, The Treasury, ND, Canberra.

⁸⁶ The Canberra Times, 'Riding Treasury's Roller coaster', 23 January 2006, 11

⁸⁷ McGarity, above n 19.

⁸⁸ See, for example, OECD, *The OECD Report on Regulatory Reform: Synthesis*, OECD, Paris, 1997, 5ff.

EMPLOYEE SHARE OWNERSHIP PLANS IN AUSTRALIA: THE TAXATION LAW FRAMEWORK

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I INTRODUCTION

Taxation law has featured prominently in the regulation of employee share ownership plans (ESOPs) in Australia. Indeed, it is largely through reforms to the taxation law framework over the past several decades that the Australian Government has sought to promote, and shape, employee share ownership.¹ This paper examines the taxation treatment of employee share ownership plans and the effect of these tax rules on current practice in the area. It also identifies the major criticisms of the current regulatory regime. While this paper is predominately concerned with broad-based employee share ownership plans – plans in which a majority of employees in the company are eligible to participate – it does briefly discuss executive-based plans. This is because it is impossible to discuss the regulation of broad-based ESOPs in Australia without discussing the perennial concern of regulators to prevent the abuse of such plans by company executives.

Part 2 of the paper identifies the key public policy rationales for the promotion of broad-based employee share ownership in Australia. An understanding of these objectives is crucial to understanding the nature and limits of the current regulatory framework. Part 3 briefly traces the relevant legislative developments. Part 4 examines the current taxation treatment of employee shares or options. Part 5 looks at current market practice in the area. Finally, Part 6 identifies some of the key difficulties associated with the current taxation regime of employee share schemes.

II PUBLIC POLICY RATIONALES FOR EMPLOYEE SHARE OWNERSHIP

Since at least the 1970s, broad-based employee share ownership has enjoyed bipartisan support in Australia. There are a myriad of rationales offered to support employee share ownership, 'informed by a variety of ideologies and intentions.'² The promotion of employee share ownership continues to be an objective of both the Liberal Party of Australia and the Australian Labour Party (ALP).³ The current federal Coalition Government has committed to doubling the incidence of employee share schemes in the workplace from 5.5 percent to 11 percent of employees by 2009.⁴ The ALP has recently foreshadowed an examination of measures to facilitate employee share ownership.⁵

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¹ There have, of course, also been reforms to the corporate law framework: see I Landau and I Ramsay, 'Employee Share Ownership Plans in Australia: The Corporate Law Framework' (Research Report, Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, March 2007).

² Cited in House of Representatives Standing Committee on Employment, Education and Workplace Relations Report, *Shared Endeavours – An Inquiry into Employee Share Ownership in Australia* (September 2000) ('*Shared Endeavours*') 30.

³ See Australian Labor Party, *ALP National Platform and Constitution*, as adopted at the 43rd National Conference, Sydney, 29 – 31 January 2004.

⁴ The Hon Kevin Andrews MP, Minister for Employment and Workplace Relations, *Media Release 04/104 – Promoting Employee Ownership* (2004).

⁵ See The Hon Wayne Swan MP, Shadow Treasurer, 'Australia's Economic Future', Keynote Address to the Labor Business Forum, Sydney, 19 September 2006.

In 1999, the Minister for Employment, Workplace Relations and Small Business, the Hon Peter Reith MP, directed a joint Parliamentary Committee to 'inquire into and report on the extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on: workplace relations and productivity in enterprises; and the economy.' The Committee's report, *Shared Endeavours*, was tabled in September 2000.

Shared Endeavours was overwhelmingly in favour of the promotion of broad-based employee share ownership plans in Australia.⁶ The Dissenting Report by the Labor members of the Committee concurred with the Majority Report that broad-based employee share ownership schemes should be encouraged. Moreover, the Labor members supported a number of the Majority Report's recommendations for the promotion of these sorts of plans. They were cautious to note, however, that while the conclusion that broad-based employee share plans better aligned employer and employee interests and fostered increased productivity and workplace harmony, seemed logical, there was no clear and objective evidence to support these rationales.⁷ Their report focused largely on their concerns with the capacity of employee share plans, as currently regulated, to facilitate tax avoidance by company executives.

Over the years, public policy makers in Australia have identified a number of key benefits arising from broad-based participation in employee share schemes. Some justifications are focused on the enterprise level, whereas others see ESOPs as part of a broader social or macro-economic project. The principal rationales that have featured in public policy discourse in Australia are outlined briefly below.

A Improving enterprise performance

Employee share ownership is identified as a means of enhancing enterprise performance through promoting worker productivity.⁸ The theoretical basis for this rationale is generally located in agency theory.⁹ Agency theory proceeds from the basis that the fact that the interests of employees are not congruent with those of the firm imposes considerable costs on the firm. There are two commonly identified ways in which ESOPs reduce agency costs: through increased productivity as a result of employee's feeling they have a direct interest in the performance of the enterprise (thus enhancing commitment to the objectives of the firm); and through lowering monitoring costs through aligning employee interests with those of the firm.¹⁰ John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, emphasised the importance of employee share ownership plans in providing incentives for employees to achieve high levels of productivity.¹¹

⁶ The Majority Report identified a range of legislative and institutional reforms that would facilitate the public policy objectives identified. Of the 45 policy recommendations, however, the Australian Government rejected close to 30. The Government appears to have rejected further calls for legislative reform in favour of a 'lighter touch' approach, embodied in the establishment in 2003 of the Employee Share Ownership Unit (ESOU) within the Department of Workplace Relations.

⁷ *Shared Endeavours*, above n 2, Dissenting Report, 290.

⁸ There is an extensive body of literature from the United Kingdom and the United States on this subject.

⁹ A Pendleton, 'Incentives, Monitoring, and Employee Stock Ownership Plans: New Evidence and Interpretations' (2006) 45 *Industrial Relations* 753.

¹⁰ *Ibid.* See also N Wilson, *ESOPs: Their Role in Corporate Finance and Performance* (1992) 24–6.

¹¹ The Hon John Howard PM, *Employee Share Plans Initiatives*, cited by the Hon Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, 'The Role of Employee Share Ownership in the New Workplace' (Speech to the Australian Employee Ownership Association (AEOA) Breakfast Briefing: Future Directions in Employee Ownership, Canberra, 29 June 2000).

The ALP has proved more circumspect in relation to the capacity of employee share ownership to improve enterprise productivity. In 2004, for example, in response to a motion in the House of Representatives for reforms to the employee share ownership framework, the Shadow Minister for Workplace Relations, the Hon Craig Emerson MP, observed that as a member of the Nelson Committee, he had discovered that the links between employee share ownership and productivity were elusive.¹² In mid-2006, the Shadow Treasurer Wayne Swan observed the link in empirical research between employee share ownership and productivity, though noted that this benefit only appeared to eventuate when ESOPs were coupled with participative management practices.¹³

Other commentators have doubted the effectiveness of ESOPs in improving enterprise performance. For example, Mong notes that not all employees will work harder as a result of share ownership as they will choose to 'free-ride' off the efforts of other employee shareholders and that rewards for increased productivity will be diluted by the number of shares held by non-employees. She also notes that incentive efforts may be offset by employees (usually executives) using financial products, such as options, to reduce their risk exposure and so may not be concerned with increased productivity.¹⁴

B Industrial relations objectives

Employee share ownership is often identified as a means of facilitating labour-management cooperation through breaking down the 'them' and 'us' mentality in the workplace. The capacity of employee share ownership to promote cooperative workplace relations has been repeatedly emphasised by the Liberal/National Party Coalition Government. Employee share ownership, for example, featured in the Coalition's 1996 Industrial Relations Policy, *Better Pay for Better Work*.¹⁵ John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, also emphasised the importance of employee share ownership plans in building a sense of participation in Australian business through giving employees a direct stake in the enterprise in which they work.¹⁶ Since this time, the capacity of employee share ownership to promote the 'mutuality of interests' in the workplace has been repeatedly identified by successive workplace relations ministers.¹⁷ Tony Abbot, in particular, proved to be a passionate supporter of employee share ownership during his time as Federal Minister for Employment Services, Workplace Relations and Small Businesses from 2001 to 2003. In his words:

... if we are ever going to have workplaces which are more like partnerships and less like battlefields, we need to have a situation where workers and managers have a better perspective on each others situation. And I think the best way to do that is through greater employee share ownership.¹⁸

¹² Commonwealth, *Hansard*, House of Representatives, Monday 1 March 2004, 25375.

¹³ Swan, above n 5.

¹⁴ S Mong, 'Employee Share Ownership Plans – Reform or Rethink' (1999/2000) 15 *Australian Tax Forum* 413, 416.

¹⁵ See the Hon Peter Reith MP, Shadow Minister for Industrial Relations, 'Better Work for Better Pay: The Federal Coalition's Industrial Relations Policy', 1 January 1996, [8.1].

¹⁶ Howard, above n 11.

¹⁷ See, eg, Reith, 'The Role of Employee Share Ownership in the New Workplace', above n 11.

¹⁸ The Hon Tony Abbott MP, Speech to the CEDA/ Telstra Political and Economic Overview Conference, 2 February 2001. Available from <<http://www.tonyabbott.com.au/news/default.asp?action=article&ID=233>>.

For others, employee share ownership is a means of enhancing industrial democracy or of bringing the employee into corporate governance.¹⁹ The ALP platform identifies the promotion of employee share ownership as a key principle to be pursued, as a means of 'Promoting Industrial Democracy and Cooperative Workplaces'.²⁰

C Contributing to national savings

The potential contribution of ESOPs to national savings was identified as a rationale for employee share schemes at least as early as the mid-1990s.²¹ In 1996, the Federal Treasurer Peter Costello observed that giving 'blue-collar Australians' a 'stake in the business' will provide them with 'the opportunity to secure for themselves the kind of financial independence this government would like to see.'²² The Prime Minister himself has emphasised the importance of employee share ownership plans in increasing the voluntary savings of Australian households and 'fostering a more balanced approach to retirement planning'.²³ In 2000, however, *Shared Endeavours* observed that the place of employee share ownership in 'a national savings program has not been fully considered by Parliament nor been the subject of clear policy.'²⁴

D Promoting innovation

Since 2001, employee share ownership has featured within the Government's initiative to promote science and innovation. The initial strategy document - *Backing Australia's Ability: An Innovation Action Plan for the Future* - published in 2001,²⁵ noted that a high-level Ministerial Committee responsible for overseeing the implementation of *Backing Australia's Ability* would, examine a number of areas in order to ensure that relevant policies provide the most effective support for R&D, its commercial application and skills development. The document identified as one of these specific areas the potential extension of employee share ownership schemes in small and medium unlisted companies, and companies in sunrise and new industries.²⁶

E Remuneration objectives

Although never highlighted as a policy objective in its own right, there have been a number of comments related to the desirability of giving employers and employees greater flexibility in determining the nature and mix of remuneration packages. For example, in a submission to

¹⁹ G Winther and R Marens, 'Participative Democracy May Go a Long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States' (1997) 18 *Economic and Industrial Democracy* 393, 394.

²⁰ ALP, above n 3, Chapter 3, [112].

²¹ See eg, the numerous second reading speeches delivered in relation to the *Taxation Law Amendment Bill (No 2) 1995*. Commonwealth, *Hansard*, House of Representatives, 22 June 1995.

²² 'Questions without Notice: Employee Share Ownership', Commonwealth, *Hansard*, House of Representatives, 6 November 1996, 6665. See also Howard, above n 11.

²³ See Howard, above n 11, and the Hon John Howard PM, 'Competence, Philosophy and Future Challenges' (Address to the National Press Club, Canberra, 1 August 2001). Available from <<http://www.australianpolitics.com/news/2001/01-08-01a.shtml>>.

²⁴ *Shared Endeavours*, above n 2, 47.

²⁵ The initial 2001 package, *Backing Australia's Ability*, which comprised \$3 billion over five years to 2005 – 06, was extended on 6 May 2004. Together, the two packages constitute a ten year, \$8.3 billion funding commitment, stretching from 2001 – 02 to 2010 – 11. See <<http://backingaus.innovation.gov.au>>.

²⁶ Available from <<http://backingaus.innovation.gov.au/docs/statement/backing.rtf>>.

the Nelson Committee, the Treasurer stated that ESOPs were “consistent with Government policy of allowing employers and employees greater flexibility and choice in their working arrangements”.²⁷

F Other objectives

The Nelson Committee identified a further objective, namely that the promotion of ESOPs could facilitate “employee buyouts and succession planning”.²⁸ The issues had been raised in submissions to the Committee and although there was no real discussion of the issues the Majority Report simply noted that using ESOPs in this way would greatly expand the level of share ownership in Australia.²⁹

III LEGISLATIVE HISTORY

Since the mid-1970s, Australian Governments have sought to reform the taxation regime so as to facilitate broad-based employee share ownership while also seeking to limit the scope for abuse of employee share plans for aggressive tax planning purposes.

The issue of whether benefits provided under these schemes would constitute income on ordinary concepts was not considered by the courts. The first Australian case relied on s 26(e)³⁰ of the *Income Tax Assessment Act 1936* (ITAA 1936). In *Donaldson v FCT*³¹ it was held that such a scheme did confer ‘benefits’, that the benefits had been ‘given in respect of employment’ and that the ‘value’ of the benefit should be included in assessable income. The first legislative provision for the taxation of employee shares in Australia was introduced in 1974 by the Whitlam Government in response to that case.³² The case held that assessable income would include the value of an option even though the option could not be assigned and could not be exercised for a period of 3 years. The value was said to be whatever a willing but not anxious person would be prepared to pay for it. The legislative reforms were introduced as one of a raft of taxation law amendments and did not form the basis of extensive debate in the Federal Parliament.

Section 26AAC was inserted into the ITAA 1936 to govern the taxation of employee benefits in the form of share issues or grants of rights to acquire shares.³³ As the Australian Taxation Office (ATO) later explained:

Section 26AAC and ESAS [employee share acquisition schemes] were intended to encourage employees to acquire an interest in their employer company and to allow employees some control.³⁴

Section 26AAC provided for the taxation of benefits that arose from shares or rights that were acquired in a company under an employee share acquisition scheme where the shares or rights were a consequence of employment or services rendered by the taxpayer or a relative. The shares or rights acquired could be in the employing company or in another company. Section 26AAC provided for the value received under an option or share plan to be measured at the time of the exercise of the option or when restrictions relating to shares were lifted

²⁷ Noted in *Shared Endeavours*, above n 2, 2.78.

²⁸ *Ibid*, Recommendation 5.

²⁹ *Ibid*, 53–4.

³⁰ Now s 15-2 *Income Tax Assessment Act 1997*.

³¹ 1974 ATC 4192.

³² *Ibid*, 12.

³³ Inserted by *Income Tax Assessment Act (No 2) 1974* (Cth).

³⁴ *Shared Endeavours*, above n 2. See also ATO, ‘Submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations’ Inquiry into Employee Share Ownership,’ Submission No 24, 30 April 1999, 6.

rather than, as had been held in *Donaldson*,³⁵ when the rights were acquired. This meant that if the shares were subject to restrictions or conditions, so that the employee was prohibited from disposing of the shares or the employee could be divested of ownership, then the employee was only taxed on the discount in the year when the restrictions or conditions were lifted. There was no limit on the period of deferral. The taxpayer could, however, elect to be taxed in the year that the shares or rights were acquired.

In 1985, the income tax base was broadened by the introduction of Fringe Benefits Tax (FBT) and a Capital Gains Tax (CGT). The impact on section 26AAC was minimal as the FBT legislation specifically excluded benefits under an ESOP³⁶ and the CGT provisions only applied on disposal of shares or rights and then only taxed the difference between the market value of the share or right and the capital proceeds on disposal.³⁷

The second significant stage in the regulation of employee share ownership schemes came in the mid-1990s. Reforms were inspired in large part by concerns that s 26AAC ITAA 1936 was being misused to create plans specifically designed for aggressive tax planning.³⁸ In its 1993 Budget, the Keating Labor Government announced a review of employee share plans, and in the 1994 – 95 Budget, the then Treasurer, Ralph Willis, announced significant reforms to employee share ownership in order to facilitate broad-based schemes whilst limiting the potential for misuse. In 1995, the Keating Government introduced Division 13A into the ITAA 1936.³⁹ In his second reading speech, the deputy treasurer, explained that the reforms were intended to reduce the unintended exploitation of the existing legislation and to increase the taxation benefits available to share schemes that encourage employees to own shares in the company for which they work.⁴⁰

The changes narrowed the concessions available to employee share schemes to those where the shares were issued in the employer or holding company of the employer and which were available to at least 75% of all permanent employees. The provisions provided that the amount to be included in a taxpayer's assessable income in respect of shares or rights acquired under an employee share plan would be the difference between the value of the share or right and any amount paid by the taxpayer to acquire the share or right. Generally, the amount was to be included in assessable income in the year that the share or right is acquired. However, providing the rights or shares satisfied certain criteria, an employee who acquired a share or right under an employee share scheme may have been eligible for the following:

- An exemption concession: an income tax exemption initially to a value of \$500 per employee per year for qualifying shares that are issued to employees under a scheme operated on a non-discriminatory basis; or
- A deferral concession: a deferral of taxation initially for up to five years but extended to ten years in the final Bill, on qualifying shares and rights. In order to be qualifying the scheme offering the shares or rights had to meet certain requirements.

The reforms were supported by the Democrats and the Greens but opposed by the Liberal/National Party opposition.⁴¹ While supportive of employee share schemes and cognisant of the need for reform of the existing provisions in s 26AAC, the opposition

³⁵ 1974 ATC 4192.

³⁶ See now s 136(1) *Fringe Benefits Tax Assessment Act 1986* definition of "fringe benefit", para (h)-(hb).

³⁷ See now Subdiv 130-D ITAA 1997.

³⁸ *Shared Endeavours*, above n 2, 12. See also ATO, above n 33, 4.

³⁹ *Taxation Laws Amendment Bill (No 2) 1995*.

⁴⁰ Commonwealth, *Hansard*, House of Representatives, 22 June 1995, 2083.

⁴¹ Commonwealth, *Votes and Proceedings*, House of Representatives, 22 June 1995, 2214; 20 November 1995, 4324.

criticised the reforms on the basis that the “complex set of income tax rules” would “make employee share acquisition schemes less attractive and less available to the Australian work force”.⁴² They would, according to numerous opposition members, both threaten the viability of existing schemes and restrict the proliferation of schemes in the future. In particular, the opposition criticised the qualifying conditions for obtaining the tax concessions as too restrictive, including the requirement that the shares be ordinary shares, thus excluding from the concessional and deferral regime those types of companies that do not issue ordinary shares; the tax treatment of share options for taxing a potential gain that may never be realised; and the five-year maximum deferral period for being too short (thus resulting in many international share option plans attracting tax before employees acquire shares). Despite the opposition the measures came into force and apply from 28 March 1995.

Even before his election to office in 1996, John Howard expressed his commitment to the promotion of employee share plans. In the 1996-7 Budget, the newly-elected Coalition government provided for the amendment of the taxation concessions for employee share schemes to “build a greater sense of employee participation in the success of Australia businesses”. This would be achieved through doubling the value of shares or rights that were eligible for the tax concession under a share scheme from \$500 to \$1000 a year per employee, with a corresponding increase in the deduction available to employers; and reducing the participation conditions for the concessional arrangements from three quarters to two thirds of permanent employees.⁴³

The Coalition Government’s election commitments were included in one of a litany of proposed, and largely unrelated, amendments embodied in the *Taxation Laws Amendment Bill (No 4) 1996* and debate surrounding these other amendments appeared to overshadow those relating to employee share schemes.⁴⁴ Nevertheless, there appeared a broad consensus in both Houses of Parliament that broad-based employee share plans should be promoted and thus that the increase in the value of shares that could be exempt from \$500 to \$1000 was desirable. Debate over the proposed amendments to employee share plans in the Senate, however, focused on the proposed reduction of the required threshold for employee share schemes from 75% to 66% and a change from ‘employees’ to ‘permanent employees’.⁴⁵ Both of these proposed changes were opposed by the Labor opposition and the Democrats on the basis that it was restrictive of the development of employee share schemes that were open to as many employees as possible and on a fair basis.⁴⁶ The proposal to reduce the threshold from 75% to two-thirds was rejected in the Senate.

The Coalition Government also amended the corporate law requirements for employee share schemes. The *Corporate Law Economic Reform Act 1999* relaxed the prospectus requirements for companies initiating employee share plans, subject to a number of conditions.

⁴² Commonwealth, *Hansard*, House of Representatives, 22 June 1995, 2087 (Peter Costello).

⁴³ Peter Costello, ‘Meeting Our Commitments’, 20 August 1996. Available from <http://parlinfoweb.aph.gov.au/piweb/view_document.aspx?id=4&table=BUDGET> 75. The budget statement identified the financial implications of this amended concession to be a reduction of \$15 million dollars for each year from 1996–1999.

⁴⁴ This Bill originated in the House of Representatives as the *Taxation Laws Amendment Bill (No 4) 1996* on 12 December 1996, and was introduced into the Senate as *Taxation Laws Amendment Bill (No 1) 1997* on 17 March 1997.

⁴⁵ See Commonwealth, *Hansard*, Senate, 27 June 1997, 5444.

⁴⁶ Senator Sherry, Deputy Leader of the Opposition in the Senate, 27 June 1997, 5444; 5465; Senator Kernot, Leader of the Australian Democrats, 27 June 1997, 5449; Senator Margetts, 27 June 1997, 5464–5

The Review of Business Taxation produced a raft of significant tax reform proposals in 1999, but, not surprisingly given that it was concerned with business taxes, did not make any recommendations concerning ESOPs.

IV THE CURRENT TAX TREATMENT OF EMPLOYEE SHARES OR RIGHTS

The taxation regime for shares acquired by employees in respect of employment is found in Division 13A of Part III *Income Tax Assessment Act 1936* (ITAA 1936) and Sub-division 130A of the *Income Tax Assessment Act 1997* (ITAA 1997) (the capital gains tax provisions). Division 13A of the ITAA 1936 applies to the acquisition of a share or right under an employee share scheme. The general rule governing the taxation treatment of employee shares is that the issuing of shares or rights under an employee share scheme is treated as a substitute for cash income for services. Tax is imposed, at marginal income tax rates, at the time the share or right is acquired. The amount to be included in the employee's assessable employment income is the difference between the market value of the share or right and any consideration provided: that is, the amount of the discount provided to the employee or service provider.⁴⁷ For example, where a company issues an employee a share with a market value of \$1.01 and the employee paid one cent as the issue price for the share, the employee would include the \$1.00 acquisition discount in their taxable income. Rules are provided for calculating the market value of the share or right. Despite the reference to *employee* share schemes, this treatment also applies to shares acquired by contractors in exchange for services rendered.⁴⁸

Under Division 13A two alternative concessions are available for shares or rights provided under schemes that satisfy certain requirements. The first type of concession allows for discounts of up to \$1000 to be provided tax free to an employee or service provider per income year (the *exemption concession*). The second type of concession allows for tax on the discount to be deferred for up to 10 years (the *deferral concession*).

This section looks first at when an employee 'acquires a share or right under an employee share scheme' for the purposes of Division 13A. It then outlines the two concessions available to 'qualifying rights' under the Division.

A Acquisition of a share or right under an employee share scheme

Division 13A applies where any shares or rights are acquired under an employee share scheme. Shares or rights are acquired under an employee share scheme if the shares or rights are acquired in respect of, directly or indirectly, employment or services rendered. The shares or rights may be acquired by an employee or a service provider or by an associate of the employee or service provider. The Division contains rules for determining the amount to be included in assessable income.

1 Any shares or rights

Division 13A applies when an employee or service provider acquires any shares or rights under an employee share scheme, whether they are shares or rights in the employer company, a related company or any unrelated company. However, in order to obtain access to the concessions, it is necessary for the shares or rights to be in the employer company or a

⁴⁷ Sections 139B(2) and 139CC(2) ITAA 1936.

⁴⁸ Section 139(C) ITAA 1936.

holding company of the employer.⁴⁹ It is also necessary that the shares are ordinary shares and that options only give rights to acquire ordinary shares.⁵⁰ In the 2006 Budget the Government announced that it would allow certain stapled securities to be provided and legislation to introduce the amendments has now completed its passage through Parliament (see below).

The term “rights” is not defined but is commonly taken to mean rights to acquire shares, eg options. An option involves the right, but not the obligation, to acquire shares in the future at a fixed price (the exercise price). In some cases the person acquiring the option pays to acquire that right but commonly in the employment case the option is acquired for no consideration. In a recent Class Ruling, CR 2006/101 (the BHP-Billiton Ruling), the Commissioner takes the view that an employee will not acquire a “right” (ie a right to acquire a share) under an employee share scheme for the purposes of Div 13A on the grant of the right where, at the time that the right is granted, it is conditional and subject to the exercise of the employer company’s absolute discretion.

In another Class Ruling, CR 2006/103 (the Brambles Ruling), the Commissioner ruled that regardless of whether or not a participating employee is given a choice to receive cash instead of a share, it is accepted that the employee will retain the right to acquire a share on exercise of an option or share right. The Commissioner did note that where the scheme is operated so that the employer makes the ultimate decision as to whether an employee receives a share or cash in lieu of a share, the right granted to the employee will not be considered a right to acquire a share for the purposes of Div 13A.

The term “rights” could also encompass other sorts of rights such as rights that vest without the recipient exercising an option or those rights that replicate shares, such as “phantom shares”. However, as already noted, in order to access the concessions, the rights must be rights to acquire ordinary shares.⁵¹

The acquisition of a share as a result of exercising a right acquired under an employee share scheme is not treated as the acquisition of a share (presumably to avoid double counting).⁵²

It is important to note that, in order to attract the operation of Division 13A, shares or rights must be acquired at a discount. The acquisition of shares for a consideration equal to or greater than market value will not be within the Division even if accompanied by some other benefit such as a low or interest-free loan.

2 *Acquired by an employee or service provider (or an associate)*

A person acquires a share when it is transferred or allotted to that person or when a person acquires a legal or beneficial interest in the share from another person.⁵³ Division 13A applies to both employees and independent contractors acquiring shares.⁵⁴ Division 13A also applies if an associate of the employee or service provider acquires shares as a result of the employment or provision of services.⁵⁵ An associate in this context includes a relative, a partner, a trustee of a trust under which the taxpayer or an associate is capable of benefiting⁵⁶ and related companies.⁵⁷ In such a case the employee or service provider will be subject to

⁴⁹ Section 139CD(3) ITAA 1936.

⁵⁰ Section 139CD(4) ITAA 1936.

⁵¹ Ibid.

⁵² Section 139C(4) ITAA 1936.

⁵³ Section 139G ITAA 1936.

⁵⁴ Section 139C(1) and (2) ITAA 1936.

⁵⁵ Ibid.

⁵⁶ For the position where the trust is an employee share trust, see below.

⁵⁷ Section 139GE ITAA 1936.

tax on the discount received by the associate.⁵⁸ Although shares or rights provided to an associate will be subject to tax under Division 13A, only shares or rights provided to an employee will be eligible for the concessions.⁵⁹

3 *Under an employee share scheme*

Shares or rights will be acquired under an employee share scheme if they are acquired directly or indirectly in respect of employment,⁶⁰ or if the parties are not in an employment relationship, in respect of services rendered.⁶¹ That is, there does not need to be any particular form of scheme but rather there must be some connection between the acquisition of the shares and the employment or services provided. If the acquisition falls within Division 13A it will be taxed under that Division rather than the other provisions of the income tax legislation. Furthermore, the acquisition will not give rise to fringe benefits tax (see below).

Shares will not be taken to be provided under an employee share scheme (and therefore not subject to Division 13A) if they are acquired for market value.⁶²

4 *Calculating the amount to be included in assessable income*

The rules for determining the amount to be included in assessable income vary according to whether the discount is assessable immediately or is deferred.

When the discount is included in assessable income in the year the share or right is acquired, the amount is the market value of the share or right less any consideration paid or given.⁶³

When the taxing time is able to be deferred (see below) and the taxpayer disposes of the share or right within 30 days of the relevant "cessation time" in an arm's length transaction, the amount to be included is the amount received on disposal less any consideration given, including any amount paid to exercise a right to acquire a share.⁶⁴

When the taxing time is able to be deferred and the taxpayer does not dispose of the share or right within 30 days in an arm's length transaction, the amount to be included is the market value of the share or right at cessation time less any consideration given, including any amount paid to exercise a right to acquire a share.⁶⁵

Where a right to acquire a share is lost without having been exercised (whatever the reason), the right will be taken never to have been acquired and any tax paid will become refundable, through an amended assessment if necessary.⁶⁶ This reflects the fact that tax may become payable even before the rights vest and that an employee may be required to pay tax before any benefit is derived. The ability to claim a refund some time later may be of little comfort in these circumstances.

⁵⁸ Section 139D ITAA 1936.

⁵⁹ Section 139CD(3) ITAA 1936.

⁶⁰ Section 139C(1) ITAA 1936.

⁶¹ Section 139C(2) ITAA 1936.

⁶² Section 139C(3) ITAA 1936.

⁶³ Section 139CC(2) ITAA 1936.

⁶⁴ Section 139CC(3) ITAA 1936.

⁶⁵ Section 139CC(4) ITAA 1936.

⁶⁶ Section 139DD ITAA 1936.

5 *Complex valuations of shares or rights required*

Division 13A contains rules for determining the market value of both listed and unlisted shares and rights on a particular day.⁶⁷ This includes quite complex rules for determining the market value of unlisted rights depending on whether the right must be exercised within 10 years or not.⁶⁸ For example, a 10 year option with an exercise price equal to current market value of the underlying share will have a taxable value of 18.4% of the exercise price/current market value.⁶⁹ In the case of both unlisted shares and unlisted rights, the issuing company will often need to have valuations done by qualified valuers at the time shares or rights are being provided which could give rise to significant cost issues. More significant is the fact that valuations may need to be done on an individual basis at cessation time which could prove to be a significant ongoing cost for the employer.

B Qualifying for concessions

In addition to setting out that the acquisition of shares by an employee at a discount will give rise to assessable income, Division 13A also offers employees two concessions if certain conditions are met. In order to be eligible for either concession the shares (or rights) must be 'qualifying shares or rights'. There are six conditions relevant to determining whether a share is a "qualifying share" but only five of those conditions apply in determining whether a right is a "qualifying right":⁷⁰

- (1) the share or right must be acquired under an employee share scheme;
- (2) the share must be in the company which is the employer of the taxpayer or in the holding company of the employer company. The concessions are not available if the recipient is not in an employment relationship (ie a contractor) or if shares or rights are acquired by an associate of an employee or if the shares are shares in an unrelated company;
- (3) the share must be an ordinary share and the right must be a right to acquire an ordinary share (although note the recent amendments to include "stapled securities" – see below);
- (4) in the case of shares, at least 75% of permanent employees must be entitled (or have been entitled) to participate in this or another employee share scheme. Permanent employees are those employed full-time or permanent part-time with 36 months service. It is still possible however to have two schemes – one that meets the 75% requirement and another scheme that is only available to, say, executives. This condition does not apply to schemes granting rights;
- (5) the employee's legal or beneficial interest in shares of the company must not exceed 5%; and
- (6) the employee must not be in a position to control more than 5% of the votes that could be cast at a general meeting of the company.

If the shares or rights are qualifying shares or rights, the taxpayer may be able to claim the exemption concession or the deferral concession but not both as the taxpayer must make an election.⁷¹

⁶⁷ Subdivision F of Div 13A, ITAA 1936.

⁶⁸ Sections 139FC and 139FJ to FN ITAA 1936.

⁶⁹ Section 139FM ITAA 1936.

⁷⁰ Section 139CD ITAA 1936.

⁷¹ Sections 139BA and 139E ITAA 1936.

1 *The exemption concession*

A taxpayer who acquires a 'qualifying share or right' may elect to have the discount included in assessable income in the year in which the shares or rights are acquired and receive \$1000 worth of discount tax-free⁷² if three additional conditions are satisfied:

- (1) there are no forfeiture of ownership conditions;
- (2) shares or rights may not be disposed of for a minimum of three years (unless employment ceases earlier); and
- (3) the scheme and any related scheme for the provision of finance must be operated on a non-discriminatory basis.⁷³

An employee share scheme or a related scheme for the provision of finance will be non-discriminatory if it is open to at least 75% of permanent employees and the essential features of the scheme are the same.⁷⁴

2 *The deferral concession*

The deferral concession is designed to address the problem that the acquisition discount is *prima facie* taxed as a realised gain on acquisition date, giving the employee a cash tax liability which they need to pay from other cash resources.⁷⁵ If the shares or rights are qualifying shares or rights and the taxpayer does not make an election to be taxed up-front, the discount amount will be deferred and included in assessable income at a future time (referred to as the "cessation time").⁷⁶ However, if there are no restrictions preventing the taxpayer from disposing of the shares or conditions that could result in forfeiture, the cessation time will be the time at which the shares are acquired.⁷⁷

Where *shares* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the restrictions on disposal or possibility of forfeiture end, the shares are disposed of, when employment ceases or 10 years.⁷⁸

Where *rights* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the rights are exercised, when the rights are disposed of, when employment ceases or 10 years.⁷⁹ If the right is exercised to acquire shares and restrictions apply or the shares are subject to forfeiture, cessation time is when the restrictions end (to a maximum of 10 years).⁸⁰

A problem that arises in this area is that a liability to pay tax can arise before any real benefit is received. For example, an employee may leave employment perhaps as a result of retirement and be required to pay tax even though the rights have not vested and may not vest for some time. As already noted, the ability to claim a refund at a later time under s 139DD does not necessarily relieve the burden that this may impose.

⁷² Section 139BA(2) ITAA 1936.

⁷³ Section 139CE ITAA 1936.

⁷⁴ Section 139GF ITAA 1936.

⁷⁵ C Rider, 'Sellers of Labour or Investors of Intellectual capital? Conceptual Problems in the Taxation of Employee Share Ownership in IP Spin-off Companies' (Working Paper, Intellectual Property Research Institute of Australia, 2005) 16.

⁷⁶ Section 139B(3) ITAA 1936.

⁷⁷ Section 139CA(1) ITAA 1936.

⁷⁸ Section 139CA ITAA 1936.

⁷⁹ Section 139CB ITAA 1936.

⁸⁰ Section 139CB(1)(c) ITAA 1936

C Taxation treatment of employer

The issue of shares or rights by a company will not generally involve any cost to the employer and so there is no amount that can be deducted. However, recent changes to the Accounting Standards require companies to expense share-based compensation provided to an employee or director, measured at the fair value at the date of grant (generally when terms are agreed between the employer and employee).⁸¹ This has led to concern that ESOPs will impact on the companies' profitability even though there is no actual tax deductible expense.⁸²

Where shares or rights are acquired on-market, for example by a trust established for the purpose by the employer company, a deduction will be available. The company providing the shares or rights under an employee share scheme (either the employer or the holding company of the employer company) may be entitled to claim a deduction for some of the costs associated with the scheme. For example, it should be possible to claim a deduction under the general deduction provision for the costs associated with setting up and administering scheme.⁸³ Where a deduction would not otherwise be available, Division 13A provides a deduction to a maximum of \$1000 for shares or rights that are qualifying and also satisfy the exemption concessions.⁸⁴ Contributions of money or property to an employee share trust may also be deductible but only at the time the employee or associate acquires the shares or rights.⁸⁵

A final issue for employers is whether the provision of shares or rights under an employee share scheme will give rise to a fringe benefits tax liability – this is discussed below.

D Other taxing provisions

On general principles it is possible that the provision of shares or rights as remuneration could give rise to tax either as a non-cash benefit or as a fringe benefit. It is also possible that any subsequent disposal of the shares or rights could give rise to capital gains tax liability.

The provisions of Division 13A are an example of statutory income and as such an amount determined under the Division is included in assessable income.⁸⁶ If Division 13A applies then a number of other taxing provisions such as section s 15-2 ITAA 1997 (formerly s 26(e) ITAA 1936) (employment benefits) and section 21A (business benefits) are expressly excluded from applying.⁸⁷ However, those provisions may need to be considered if Division 13A does not apply.

Prima facie, the provision of shares or rights would give rise to a liability for the employer to pay fringe benefits tax. However, the definition of "fringe benefit" expressly excludes a benefit constituted by the acquisition of a share or right that falls within Division 13A⁸⁸ or the

⁸¹ AASB 2 issued by the Australian Accounting Standards Board. International Financial Reporting Standards apply from 1 January 2005 – see IFRS 2.

⁸² The Treasurer, Peter Costello, in Press Release 26/04 (30 April 2004) announced that there would be no change to the deductibility provisions despite changes to the Accounting Standards relating to expensing options granted to employees.

⁸³ Section 8-1 ITAA 1997.

⁸⁴ Section 139DC ITAA 1936.

⁸⁵ Section 139DB ITAA 1936.

⁸⁶ Section 6-10 ITAA 1997.

⁸⁷ Section 139DE ITAA 1936.

⁸⁸ Section 136(1) *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986), definition of 'fringe benefit', para (ha). There is also an equivalent provision for benefits provided under a previous legislative scheme applying to employee share schemes in existence before 1995 (para (h)).

acquisition of money or property by certain employee benefit trusts.⁸⁹ It should be noted though that the provision of other benefits, such as the provision of financial assistance to acquire the shares or rights, could give rise to fringe benefits tax liability for the employer.

A final point to note is that the subsequent disposal of shares or rights may give rise to capital gains tax liability. The interaction between Division 13A and the capital gains tax provisions is considered below.

E Interaction with Capital Gains Tax

As outlined above, the general position is that the discount an employee receives on market value at the time of acquisition of the share will be taxed on acquisition under Division 13A (subject to the concessions). For capital gains tax purposes, the difference between the cost base (generally market value) and consideration on disposal will be taxed as a capital gain.⁹⁰ As a general rule, the disposal of a share or right will give rise to a capital gain if the consideration on disposal (or in certain cases the market value at disposal) is greater than the cost base of the share or right.⁹¹ A capital loss will arise if the capital proceeds are less than the reduced cost base.⁹² The cost base of a share or right acquired under an employee share scheme depends on whether the discount is subject to tax at the time the shares or rights are acquired or whether liability to tax is deferred.

If the discount on shares or rights is subject to tax on acquisition, the cost base of the share or right will be market value at the time of acquisition.⁹³ This means that the discount will be taxed under Division 13A and the taxpayer will then be able to use the market value at the time of acquisition to determine the capital gain or loss.

If tax is deferred and the share or right is disposed of within 30 days of cessation time, the capital gains tax provisions do not apply.⁹⁴ This means that the difference between market value of the share or right and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A.

If tax is deferred and the share is disposed of more than 30 days after cessation time, the cost base of the share is market value at cessation time.⁹⁵ This means that the difference between market value of the share or right at cessation time and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A. Any subsequent increase in the value of the share or right will be subject to tax as a capital gain.

An important point to note is that since September 1999, certain capital gains have been eligible for the “CGT discount” which means that only 50% of the nominal gain is included in assessable income.⁹⁶ This may mean that it is advantageous to bring forward the taxing time under Division 13A and receive less of any relevant gain in the value of shares or rights as an “income” gain subject to tax under Division 13A and more of any relevant gain as a “capital” gain.

⁸⁹ Ibid, para (hb).

⁹⁰ Net capital gains and net capital losses are calculated under Parts 3-1 and 3-3 ITAA 1997. A net capital gain is included in assessable income (s 102-5). A net capital loss can be carried forward and offset against future capital gains (s 102-15).

⁹¹ Section 104-10(4) ITAA 1997. Div 116 provides rules for determining ‘capital proceeds.’ Divisions 110 and 112 provide rules for determining ‘cost base.’

⁹² Section 104-10(4) ITAA 1997. The reduced cost base is a modified cost base used to calculate a capital loss. It does not include certain costs that can be included to determine a gain (Subdiv 110-B).

⁹³ Section 130-80(2) ITAA 1997.

⁹⁴ Section 130-83(2) ITAA 1997.

⁹⁵ Section 130-83(3) ITAA 1997.

⁹⁶ Division 115 ITAA 1997. A number of conditions must be satisfied to take advantage of the discount eg the shares must have been held for at least 12 months.

F Recent developments

1 Rollover relief

Changes in 2004 provide for CGT rollover relief for rights or shares acquired under an ESOP when a corporate restructure occurs. Where an employee has deferred tax liability under an ESOP, the taxing point could be triggered where the shares or rights are acquired under a takeover or other corporate restructure. From 1 July 2004 rollover relief is available in respect of the shares or rights provided the takeover or restructure is for 100% of the company, the consideration received is “matching shares or rights” in the acquirer and certain other conditions are satisfied.⁹⁷

2 Cross border employee shares or rights

Measures introduced in 2005 apply to an individual who works in more than one country or changes country of residence.⁹⁸ The legislation provides that where a person acquires shares or rights while employed offshore and then later becomes an employee in Australia while still engaged in employment or service relevant to the acquisition, will be subject to Div 13A at the point of becoming an Australian employee.⁹⁹ The measures generally apply from 26 June 2005.

3 Stapled securities

Current law requires qualifying shares to be ordinary shares and rights to give the right to acquire ordinary shares. In the 2006 Budget the Government announced that it would extend the employee share scheme concessions and related capital gains tax treatment to stapled securities that include an ordinary share and are listed on the Australian Stock Exchange. The measures are contained in *Taxation Laws Amendment (2007 Measures No 1) Bill 2007* which completed its passage through Parliament on 28 March 2007 and at the time of writing was awaiting Royal Assent.

V CURRENT PRACTICE

One of the difficulties in identifying current trends is that comprehensive information on the number, nature and extent of employee share plans in Australia, and the number of employees in plans is not collected by any government department such as the Australian Bureau of Statistics. Nor is data collected by bodies such as the ATO or the Australian Securities and Investment Commission (ASIC) despite both bodies having significant regulatory responsibilities in the area. In *Shared Endeavours* it was suggested that “over 5% of the Australian workforce...holds equities under employee share plans”.¹⁰⁰ This contrasts with approximately 7% in the UK, 10% in the US and 23% in France.¹⁰¹

Despite the lack of official information, several private bodies have conducted surveys that provide some insights however. In 2003, KPMG released the results of a survey of 800 Australian companies entitled “Employee Share and Option Schemes Survey Report”.¹⁰² That

⁹⁷ See ss 139DQ – 139 DS ITAA 1936 and ss 130-83 and 130-95 ITAA 1997.

⁹⁸ The measures were introduced by the *New International Arrangements (Foreign-owned Branches and Other Measures) Act 2005*.

⁹⁹ Section 139BA(2), (2A) ITAA 1936.

¹⁰⁰ *Shared Endeavours*, above n 2, 26.

¹⁰¹ J Lenne, R Mitchell and I Ramsay, ‘Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes’ (2006) 14 *International Journal of Employment Studies* 1.

¹⁰² Another survey by Mercer Human Resources Consulting was released in 2002.

report identified that employees of public listed companies are significantly more likely to be offered equity based compensation schemes as employees of other companies. Specifically, 80% of public listed companies that responded had some sort of scheme compared with 38% of public unlisted companies and 16% of private companies.

In relation to the types of schemes being offered there would appear to be significant diversity as to the type of equity, the nature of the employee contribution (if any) and the conditions that must be satisfied. For example, the survey found that the most common types of schemes were option or option- based schemes as opposed to share plans (49% of schemes were in this category). The key differences relate to an entitlement to dividends (not available under an option plan) and downside risk protection (not generally available under a share plan). Under an option plan employees are offered options which can be exercised after a vesting period (usually 3 to 5 years) for a stated exercise price. The option itself (as opposed to the underlying share) is granted for nil or nominal payment. There is no commercial downside risk in holding options. That is, if the shares are 'out of the money' (i.e. the share price is less than the exercise price), the employee simply does not exercise the option. Rather the option is only exercised if and when the shares are 'in the money' (i.e. the share price exceeds the exercise price). If the shares remain out of the money, the options are simply allowed to lapse. Prior to the exercise of the option, the employee does not receive dividends and has no other shareholder rights. The survey found that the most common type of option plan set the exercise price at the market value at the time the options were granted (MEPO) but there were also plans with lower exercise prices (LEPO) as well as zero exercise price options (ZEPO). Plans with a zero exercise price have been becoming more common. Another significant feature is the development of Performance Rights Plans which generally involve the issue of options for no consideration with a nil exercise price but subject to the satisfaction of various performance criteria. This is particularly the case with executive remuneration as opposed to all-employee schemes. The most common performance hurdle was found to be Total Shareholder Return (TSR) but others included earnings per share (EPS) and share price performance.

The survey also identified that 12% of companies with a scheme had a \$1000 tax-exempt plan. As already notified to access this exemption the employee must elect to be taxed upfront. The view was expressed in the survey that the decline in the use of such plans could be linked to the state of the share market generally in the period covered by the survey and that companies are less likely to offer free or discounted shares to employees during periods of slow profit performance.

If the acquisition of shares or rights requires some contribution by the employees there are various methods available to achieve this other than requiring the employee to provide cash. For example, the acquisition may occur as a result of a salary sacrifice so that the employee elects to receive part of their remuneration as shares, rather than as cash (ie the employee's cash salary is reduced). Provided the requirements of Div 13A are met, the employee will be entitled to tax deferral. One high profile salary sacrifice arrangement is that of the CEO of ANZ who was reported to have earned only \$50 in cash salary last year (i.e. less than \$1 per week), receiving the rest of his remuneration in shares and performance rights in ANZ.¹⁰³ The ATO accepts that a salary sacrifice, that is, an arrangement entered into before income is earned that provides benefits of a similar value instead of cash, will be effective for tax purposes. The value of the benefits will not be included in the employee's assessable income and the employer will pay fringe benefits tax (if any) on the value of the benefits provided.¹⁰⁴

¹⁰³ Richard Gluyas, "ANZ Chief Ups pay to \$7.3 million", *The Australian*, 15 November 2006.

¹⁰⁴ Taxation Ruling TR 2001/10.

Loan plans, discussed above are also a common way of financing acquisitions. Typically the loan will be limited in recourse to the value of the shares so that there is no downside risk.

There has also been a trend by employers to have plans operated through a trust or to use a third party 'plan company'. This is seen as providing flexibility as to the source of shares to be provided under the plan, that is, either existing shares acquired on market or new shares issued by the company. The use of a third party can also address the issue of deductibility. The introduction of accounting standards in 2004 which require companies to expense the value of share and option grants has highlighted the fact that such companies will generally not be entitled to claim a deduction despite the accounting requirement.

Another trend identified in the press has been the practice of executive employees hedging shareholdings, that is, locking in profits but still holding shares in order to seek concessional capital gains tax treatment and/or to limit disclosure to shareholders. For example, the CEO of Channel Seven recently exercised 500,000 options and immediately entered into put and call options over the resulting shares. The CEO of Westpac recently exercised 677,886 options and immediately entered into cap and collar arrangements with CBA.¹⁰⁵ This hedging trend appears to replace the sale of vested option arrangements which were common a couple of years ago. The Australian Council of Super Investors found that 34 companies were engaging in hedging even though many companies did not respond to its call for information.¹⁰⁶

What does appear to be the case is that ESOPs are strongly based on Australian income tax law and changes to it. For example, in the early-mid 1990's ESOPs were put on hold for 2 years between the period starting when the Government announced that the old tax regime (section 26AAC) would be replaced and ending when the Government announced the rules now comprising Division 13A. Similarly, a current trend is to implement plans for stapled securities in light of the 2006 Federal Budget announcement. This is a very major development given the prevalence of listed property trusts and infrastructure funds in the market.

A Performance hurdles

One trend that has been identified is that companies are becoming more likely to include various performance hurdles that must be met before the rights are exercised. This cannot be attributed to any changes in the tax treatment of ESOPs but can probably be linked to changes in corporate legislation and changes in shareholder expectations relating to executive remuneration, especially in light of media reports of extremely large payouts to (often failed) executives.

For example, the AASB introduced Accounting Standard AASB 124 in 2005 which requires disclosure of the value of all forms of executive remuneration. Furthermore, the Corporations Act was amended in 2004 and now requires mandatory reporting of a company's remuneration policy. The Australian Stock Exchange urges companies to 'remunerate fairly and responsibly' and provides for shareholders of listed companies to ask questions about, or comment on the remuneration report and also to pass a non-binding resolution on the adoption of the remuneration report.

The issue, especially in relation to CEOs, generally seems to be about how much remuneration should be fixed and how much should be variable or "at risk". There is also generally considerable discussion about the appropriateness of various measures of performance.

¹⁰⁵ Christopher Webb, "Director's Dealings", *Sunday Age*, 14 May 2006, p 29.

¹⁰⁶ Michael West, "Push to Ban Bosses' Secret Deals", *The Australian*, 14 August 2006, p 19.

B The provision of shares or rights using an employee share trust

The provision of shares or rights through an employee share trust involves transferring shares or right or money or other property to a trustee to enable the trustee to acquire shares on-market and subsequently provide those shares or rights to employees or their associates. The use of such a trust can provide a number of benefits to an employer. For example, according to *Shared Endeavours* one benefit is that it reduces the number of entities subject to taxation and focuses taxation liability on the beneficiaries of the plan.¹⁰⁷

The provision of shares or rights to a trust, or the transfer of money or property to enable shares or rights to be acquired, will have no immediate tax consequences for the employee. This is because the employee will only acquire the share or right when they acquire the legal or beneficial interest in the share or right from the trustee. This is implicitly recognised in Division 13A which provides for deductibility in respect of the provision of money or property to a person for the purpose of enabling another person (the ultimate beneficiary) to acquire a share or right under an employee share scheme, but not until the ultimate beneficiary acquires the share or right.¹⁰⁸ This suggests that the acquisition by the trust will not be treated as an acquisition by an associate of the employee even if the employee is "capable of benefiting under the trust".¹⁰⁹ Furthermore, the section dealing with acquisition of a share or right merely refers to acquisition from another person (not necessarily from the employer).¹¹⁰ For capital gains tax purposes, the first element of the cost base (or reduced cost base) is market value when the employee first acquired a beneficial interest in the share or right.¹¹¹

The trustee of the employee share trust does not acquire a share or right under an employee share scheme if it is "the trustee of a trust whose sole activities are obtaining of shares, or rights to acquire shares, and providing those shares or rights to employees of a company or to associates of those employees".¹¹² This is consistent with the general tax treatment of trusts. For capital gains tax purposes, where a beneficiary of an employee share trust becomes absolutely entitled to a share or right, any capital gain or loss the trustee (or beneficiary) makes is disregarded if the beneficiary is an employee of a company; the terms of the trust require or authorise the trustee to transfer shares or rights; the rights were acquired under an employee scheme and the employee did not acquire the shares for more than the trustee's cost base.¹¹³

An important consideration for the employer proposing to provide shares or rights at a discount is the issue of deductibility.¹¹⁴ This is because the issue of shares or options by a company does not generally involve a deductible outgoing, even though it clearly involves some sort of "cost" to shareholders of the issuing company. However, it is generally accepted that an employer will be entitled to a tax deduction under the general deduction provision¹¹⁵

¹⁰⁷ *Shared Endeavours*, above n 2, 124–8.

¹⁰⁸ Section 139DB ITAA 1936.

¹⁰⁹ Although the Commissioner has long held the view that the trustee could be an associate (see TR 1999/5), the Full Federal Court has recently confirmed that this is not the case: *FCT v Indoороopilly Childrens Services (Qld) Pty Ltd* [2007] FCAFC 16 (22 February 2007).

¹¹⁰ Section 139G(d) and (e).

¹¹¹ Section 130-85(3) ITAA 1997.

¹¹² Section 139C(5)

¹¹³ Section 130-90 ITAA 1997.

¹¹⁴ Other benefits of establishing an employee share trust include the fact that it facilitates forfeiture and disposal where necessary.

¹¹⁵ Section 8-1 ITAA 1997.

in respect of a non-refundable contribution made to an employee share trust for the purpose of the trust using those funds to provide shares to employees of the contributor (by way of subscription or on-market acquisition) as part of an employee's remuneration package. This is implicitly recognised by a provision that allows a deduction where money or property is provided under a trust arrangement (although not until the employee actually acquires the shares or rights).¹¹⁶

An advantage of establishing an employee share trust is that the provision of money or property to a trust will not attract fringe benefits tax where "the sole activities of the trust are obtaining shares, or rights to acquire shares in the employer company or its holding company and providing those shares or rights to employees or associates of the employees".¹¹⁷ As noted below, the provision of other benefits, such as financial assistance, may give rise to fringe benefits tax liability for the employer.

C The provision of shares or rights accompanied by a low or interest-free loan

The provision of a loan by an employer (or associate or a third party under an arrangement) to an employee (or an associate) will attract the operation of the *Fringe Benefits Tax Assessment Act 1986* (Cth) as a benefit provided in respect of employment.¹¹⁸ The value of the benefit is the difference between a benchmark rate of interest and the rate of interest actually paid.¹¹⁹ If the loan is provided interest-free or at an interest rate below the benchmark rate, the difference will be subject to fringe benefits tax and tax will prima facie be payable by the employer at 46.5% on the "grossed-up value" as defined. However, as the loan is used to acquire income producing assets (the shares or rights), the value of the benefit will be reduced to zero under a rule known as the 'otherwise deductible' rule.¹²⁰ The employer will not be subject to tax with respect to the loan benefit provided. Furthermore, the employee will not be subject to tax with respect to the loan.¹²¹

If the loan is used to acquire shares or rights at a discount, Division 13A will apply to the discount and if the conditions discussed above apply the employee will be able to access the concessions.

If the loan is used to acquire shares or rights at full market value, the shares themselves will not be subject to Division 13A and the employee will not be able to access the concessions.

A point for private (i.e. non-listed) companies is that the making of a loan to an employee who is a shareholder in the company (or an associate of a shareholder) could be treated as a deemed dividend from the company and therefore included in the assessable income of the recipient.¹²² There is however an exception if the loan is made solely for the purpose of enabling a shareholder or associate to acquire shares or options under an employee share scheme but only if the shares or rights are qualifying shares or rights within Division 13A.¹²³

An alternative way in which to finance the acquisition of shares may be to offer the shares or rights at market value and enter into a salary sacrifice arrangement with the employee (see below).

¹¹⁶ Section 139DB ITAA 1936.

¹¹⁷ Section 136(1) FBTA 1986, definition of 'fringe benefit' para (hb).

¹¹⁸ Section 136(1) definition of 'fringe benefit' FBTA 1986.

¹¹⁹ Section 18 FBTA 1986. The 'benchmark interest rate' is determined by the Reserve Bank. For the FBT year ending 31 March 2006 the rate was 7.05%.

¹²⁰ Section 19 FBTA 1986.

¹²¹ Sections 23L ITAA 1936.

¹²² Section 108 and Div 7A (ss 109B to 109X) ITAA 1936.

¹²³ Section 109NB ITAA 1936.

D Plans that fall outside Division 13A

If shares or rights are offered at a discount to employees but the shares or rights are non-qualifying, the benefit received will be subject to tax under Division 13A but no concessions will be available.

Examples include:

- Shares or rights in a company that is not the employer or the holding company of the employer;
- Where the recipient is not in an employment relationship but is an independent contractor;
- Where the recipient is an associate of an employee;
- Where the plan or another plan relating to shares is not open to at least 75% of permanent employees (i.e. employees with at least 3 years service with the company);
- Where the employee becomes entitled to more than 5% of the shares in the company;
- Where the shares are not ordinary shares or the rights are rights to acquire shares that are not ordinary shares; or
- Where rights are provided in a business structure other than a company eg units in a unit trust¹²⁴ or interests in a partnership.

Where a scheme falls outside Division 13A it is necessary to consider other taxing provisions such as ss 6-5 and 15-2 (employment benefits) ITAA 1997. There are two other situations that need to be considered. The first is a scheme that involves the provision of shares or rights at full market value and the second involves schemes that offer interests that are not "shares or rights".

1 Offering shares or rights at full market value

The acquisition of shares or rights for a consideration equal to the market value of the shares or rights when they are acquired is not an acquisition under an employee share scheme and therefore not covered by Division 13A.¹²⁵ Generally, the provision of shares or rights to employees for market value would not give rise to a benefit and so would not attract any tax liability. An employer may, however, prefer to provide the benefit by other means. For example, the provision of an interest free loan will generally not attract fringe benefits tax liability where the loan funds are used to acquire income-producing assets such as shares (see above). However, the making of a loan in these circumstances may attract the deemed dividend provisions and the exclusion that applies where the loan relates to an employee share scheme within Division 13A will not be available (see above). Alternatively, the acquisition of shares or rights may be financed by a salary sacrifice arrangement. The main issue here will be to ensure that the salary sacrifice arrangement is "effective". The Commissioner has indicated that such an arrangement will be effective if the arrangement is entered into before the amount to be sacrificed has been earned.¹²⁶ If the arrangement is not effective, the Commissioner will treat the amount as having been derived by the employee and require the amount to be included in assessable income. The normal practice is to make these arrangements at the start of an income year to ensure that they are treated as effective. Regardless of how the acquisition is financed, the employee will be able to derive any capital

¹²⁴ The recent changes that permit the issuing of stapled securities do permit entities such as listed property trusts to come within Div 13A.

¹²⁵ Section 139C(3) ITAA 1936.

¹²⁶ Taxation Ruling TR 2001/10.

gains on the shares as a discount capital gain and only pay tax on 50% of the nominal gain. This may be regarded as a preferable way to provide the benefit particularly as it means that the shares or rights do not have to try to fit within the restrictive conditions that must be satisfied to enable an employee to access the Division 13A concessions.

2 *Schemes that offer interests that are not shares or rights.*

Division 13A only applies when the interest being provided is a 'share or right'. Some employers have chosen to step outside the Division and offer benefits that replicate share ownership but do not involve the acquisition of shares or rights. These schemes are sometimes referred to as "replicator share plans" or "phantom", "synthetic" or "shadow" plans. *Shared Endeavours* noted that replicator share plans are used "where the company cannot or is unwilling to issue equities in itself".¹²⁷ The plans provide benefits that "mimic the benefits they would have received had they held shares in the company".¹²⁸ Benefits provided under such plans will not be subject to tax under Division 13A and will not be eligible for concessions under that Division. Any non-cash benefit received by an employee in respect of employment will be subject to tax either under s 15-2 ITAA 1997 (which requires the recipient to include the value to the taxpayer of the benefit in assessable income) or as a fringe benefit (in which case the employer will pay tax on the value of the benefit as determined under the FBTA 1986). Typically the plan will aim to provide the benefit at market value to avoid payment of tax and to provide the benefit either in the form of a low or interest-free loan or salary sacrifice to fund the acquisition of the interest. Alternatively, or in addition, the benefit may be derived if the shares when subsequently disposed of are eligible for discount treatment.

Although these types of schemes may avoid the operation of Division 13A, *Shared Endeavours* noted that they were not used very much in Australia.¹²⁹ This may be related to the fact that under the Financial Services Regulation provisions in the *Corporations Act 2001 (Cth)*, such rights will probably be treated as derivatives and be subject to the onerous disclosure obligations in Chapter 7 of the *Corporations Act*.

VI DIFFICULTIES WITH THE CURRENT TAX REGIME

There are a number of problems in the use of the tax concessions as a tool for regulating employee share schemes. These issues are outlined broadly below.

A Cost and complexity

If an employer wishes to offer shares to employees it must comply with regulatory requirements in the *Corporations Act* designed to provide information to investors. Although the ASIC has provided conditional relief from disclosure requirements for employee share schemes, the preconditions for accessing this relief can be quite difficult to satisfy.¹³⁰ Employers and employees also need to consider the detailed taxation requirements. As already noted there are different consequences depending on what is offered, on what terms the offer is made and a range of other structural issues. For these reasons start-up costs for employers can be very high. Legal drafting of documents is expensive as they must be precise (for tax purposes) and helpful for employees (in plain English). There are also costs

¹²⁷ *Shared Endeavours*, above n 2, p xxi

¹²⁸ *Ibid.*

¹²⁹ *Ibid.*, 20.

¹³⁰ See Landau and Ramsay, above n 1.

of educating the administrators – for example, those in human resources or in the company tax group and legal groups. Standard or ‘off the shelf’ plans invariably fall foul of the tax rules with serious consequences. There are added costs if binding tax rulings are sought, which is common but often unnecessary.

On-going costs of administering an employee share plan can be high especially if an external administrator (such as Computershare) is used. Also, there may be costs associated with obtaining external advice for unique employee circumstances that continually arise. Educating employees (both administrators of the plans and participants) and responding to queries especially if they are not commercially literate can also be costly. Furthermore there is a need to review plans and documents each time an offer is made given the rapid and numerous changes in tax law.

B Inflexibility

Work done to date suggests that a ‘one-size fits all’ approach to the concessions is increasingly less appropriate to meet the emerging diversity and flexibility of the workplace and work practices across the spectrum from small start-up companies in sunrise industries to large listed companies with transnational workforces. For example, the author has been involved in a study that highlighted the difficulty faced by a start-up company in meeting the conditions for the available tax concessions.¹³¹ Rider has also argued that there are conceptual problems in treating an individual involved in an intellectual property commercialisation who receives shares in exchange for their labour in the same way as an employee who receives fixed cash salary regardless of the fortunes of the enterprise.¹³² In his view such persons are more like at-risk investors and should receive the tax treatment available to investors.¹³³

The limited terms on which ESOP benefits may be provided and the limited component of overall remuneration which they can provide, also reflect an outdated view of the appropriate taxation treatment of labour income.

C Stringency of requirements to access concessions in Division 13A

The qualifying rules for the two concessions in Division 13A have attracted significant criticism. In particular it is argued that the rules are too strict and have the effect of constraining the growth of employee share ownership in Australia.¹³⁴ The restriction of employee share schemes to companies that issue ordinary shares or rights is problematic for smaller companies.¹³⁵ Companies who cannot or are unwilling to issue ordinary shares to employees are unable to access the concessions in Division 13A. This is more likely to be the case where the company is small and control is highly valued by the owners. It is also clear that if the business is structured as a trust or a partnership rather than as a company, the provisions of Div 13A do not apply.

Limiting the availability of both concessions under Division 13A to employees who hold a legal or beneficial interest in more than 5% of the shares in the employer, or are in a position

¹³¹ C Rider et al, ‘Taxation Problems in the Commercialisation of Intellectual Property’ (Working Paper, Intellectual Property Research Institute of Australia, 2005) Chapter 9.

¹³² Rider, above n 72, 2.

¹³³ Ibid.

¹³⁴ See, eg, Mong, above n 14, 416; Employee Ownership Group, ‘Employee Share Ownership in Australia: The Future’ (undated).

¹³⁵ See, eg, *Shared Endeavours* above n 2; Employee Ownership Group, above n 126, 5; Lenne, Mitchell and Ramsay, above n 96.

to cast, or control the casting of, more than 5% of the maximum number of votes that may be cast at a general meeting of the employer, has also come under sustained criticism. The 5% limit may prevent smaller businesses from accessing the taxation concessions. It also prevents employee buyouts from occurring under Division 13A.¹³⁶

The requirement that the scheme or another scheme be available to 75% of permanent employees is also problematic for start-up companies with a small number of employees. It should be noted that the Commissioner does have discretion to determine that the condition has been satisfied¹³⁷ and it may be that, in the case of a new company, the Commissioner would do so if the scheme was open to 75% of current employees. The reference to permanent employees as full or part-time employees with at least 36 months service makes this condition impossible to satisfy for start-up companies. It may, however, be possible to obtain the deferral concession which is often seen as a more attractive option for providing executive remuneration.

Shared Endeavours made a number of recommendations to ease some of the requirements for qualifying shares and rights, particularly to facilitate the use of employee share schemes in 'sunrise enterprises'.¹³⁸ The Government, however, did not support any of these recommendations.¹³⁹

D The \$1000 tax exemption

The \$1000 tax exemption available under Division 13A has been criticised for being too low. According to Price, for example, it 'equates to the bare minimum of employee ownership.'¹⁴⁰ In submissions to the Nelson Committee, a number of companies and accountancy firms argued that the threshold was too easily exceeded, particularly where employees are given the opportunity to participate in both share and option plans.¹⁴¹ The Australian Employee Ownership Association (AEOA) argued that the effect of the \$1000 threshold was to encourage wide but not deep employee shareholding. In its submission to the Nelson Committee, KPMG presented results from its survey, which found that 35 percent of respondents stated that they would introduce an employee share scheme if the tax exemption was increased to \$2000 per employee per year.¹⁴² Submissions to the Committee also argued that the exemption should be indexed. These arguments were rejected by the Treasurer, who argued that the Government had already doubled the exemption (from \$500 to \$1000) and that indexing the concession would be anomalous, given that neither personal income tax scales or the income free threshold are indexed.¹⁴³ The *Shared Endeavours* Majority Report recommended that the tax-exempt concession be increased, though conceded that it was difficult to specify an increased amount in the absence of Treasury estimates of the costs associated with any such reforms.¹⁴⁴

¹³⁶ *Shared Endeavours* above n 2, 155.

¹³⁷ Section 139CD(5) ITAA 1936.

¹³⁸ *Shared Endeavours*, above n 2, Recommendations 32–39.

¹³⁹ Treasurer's Press Release 14/03, 27 March 2003.

¹⁴⁰ G Price, 'Employee Ownership: Reform Opportunity Lost?' *Keeping Good Companies*, July 2003, 331.

¹⁴¹ See *Shared Endeavours*, above n 2, 152–5.

¹⁴² Cited in *ibid*, 153.

¹⁴³ *Ibid*, 154.

¹⁴⁴ *Ibid*, Recommendation 32.

E Capital Gains Tax treatment

An aspect of the current taxation treatment of employee shares that has attracted considerable criticism is the extent to which employee share schemes should attract the CGT discount treatment for capital gains. Price has argued that there is a 'glaring inconsistency' in the taxation treatment of plans under Division 13A in which tax-exempt plans attract CGT discount treatment but tax-deferred plans do not.¹⁴⁵ With tax-deferral plans, the gains in value on employee shares are also taxed as income. This inconsistency is also criticised by the Employee Ownership Group, who argues that this creates a bias towards exempt plans.

Shared Endeavours recommended that all employee share schemes should have the same CGT treatment afforded to superannuation and other tax-advantaged investment savings vehicles.¹⁴⁶

F Potential for Abuse

In its Dissenting Report to *Shared Endeavours*, the minority argued that although the original intention of the tax concessions for ESOPs was to encourage the ownership of shares in companies by the employees of those companies, over a number of years such plans had 'become vehicles for aggressive tax planning for the benefit of company executives.'¹⁴⁷ Wariness of policy reform on employee share ownership in the past has been attributed in part to the fear of the Treasury of tax abuse.¹⁴⁸

The lack of published information relating to the number, structure and incidence of ESOPs makes it difficult to identify particular types of abuses but this is an area that certainly requires more attention.

The Dissenting Report emphasised that the government should encourage the growth of what it termed 'genuine' or 'bona fide' employee share plans and should develop anti-avoidance measures to deal with the abuse of plans 'that are available only to executive, high income employees and have as their real purpose the tax effective or tax free provision of remuneration.'¹⁴⁹

VII CONCLUSION

While a diverse range of rationales have been put forward for employee share ownership, it is difficult to determine precisely which of these underpin contemporary regulatory initiatives towards the practice.¹⁵⁰ Government needs to identify exactly what the underlying policy rationale is for providing the tax concessions that are currently available.

The extreme complexity of the law in this area, including the overlap of common law, Fringe Benefits Tax, Capital Gains Tax and, potentially, Part IVA of the ITAA 1936, highlights the inherent difficulties of the income tax as a base. Accordingly it seems inevitable that attempts to use income tax concessions to encourage wider share ownership are bound to be unsuccessful and counterproductive.

A further concern is that various aspects of the tax treatment imposed on ESOPs appear to be inefficient. Some of those concerns relate to the bias in favour of listed companies and

¹⁴⁵ Price, above n 132, 330.

¹⁴⁶ *Shared Endeavours*, above n 2, Recommendation 27.

¹⁴⁷ *Ibid*, 280.

¹⁴⁸ Price, above n 132, 331.

¹⁴⁹ *Ibid*, 277.

¹⁵⁰ This observation is also made in Lenne, Mitchell and Ramsay, above n 96.

against small and start-up companies, the different tax treatment that applies to employee share owners compared with other investors and the different tax treatment afforded to different types of employee remuneration.

An overriding concern is the lack of data available on various aspects of ESOPs. This lack of data makes it difficult to identify whether the tax rules operate to encourage or discourage employee share ownership and what steps any future government should take in either trying to encourage employee share ownership or to act to restrict potential abuses of the concessions.

OPERATING AND FINANCE LEASES IN AN INCOME TAX CONTEXT

GEOFFREY HART*

In the past few years there have been several important taxation cases involving financing by means of leasing and the deduction of rental payments rather than financing by borrowing secured by mortgages. There have also been a number of rulings addressing the issue of tax avoidance in a leasing context¹. These cases have involved lease financing of luxury cars², sale of leased property by lessees above residual values³, and sale and leaseback of fixtures⁴. In these cases there have been considerable tax advantages to the lessee who might otherwise have chosen to finance by borrowing. If the taxpayer were to borrow in order to acquire depreciable assets, the repayments would be split up into principal and interest, and the debtor would depreciate the assets. If the taxpayer leases the depreciable asset from a financier, then the financier as holder depreciates and the lessee deducts the rental payments which are entirely on revenue account. At first blush there would appear to be no great tax advantage since the assets are depreciated by one party and what is entirely deductible as revenue outgoings to the lessee is fully assessable to the lessor. The problem from the revenue's point of view is that the financier/holder of the asset depreciates it, and at the same time the lessee's payments are entirely deductible. Yet the lease documents generally provide that the asset is to be sold at the end of the lease for a residual value which is invariably below its market value. An example of this occurred in *Granby Pty Ltd v FCT*⁵ where the lessee purchased depreciating assets at the end of the lease and shortly thereafter sold them for a net gain of \$123,558. This was an assessable capital gain. The standard lease does not give the lessee any right or obligation to acquire the depreciated asset, so taxation law must regard the payments as being entirely on revenue account. There is a capital allowance for the financier/lessor under Division 40 of ITAA 1997 and there is in commercial effect a capital allowance to the lessee who has purchased the asset below its market value at the expiry or termination of the lease using fully deductible payments.

In spite of these tax advantages there are sound commercial reasons⁶ for using leases in a business context and these are not necessarily tax related, and even when there is a tax advantage, the dominant purpose of their use is not to gain a tax benefit in breach of Part IVA of ITAA 1936. In the commercial world business people have drawn distinctions between various types of leases, namely finance leases and operating leases. These distinctions are not reflected in the legal form of the underlying contracts, and taxation law generally regards all leases as operating leases⁷. Although there are some tax advantages in leasing, these advantages would be entirely eliminated if taxation law adopted the accounting approach of treating finance leases as equivalent to a conditional sale and allowing the lessee to be the

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¹ Taxation Ruling TR 2006/13 replacing Taxation Ruling TR 95/30 Income Tax: sale and leasebacks; Taxation Ruling TR 2005/20 Income Tax: the interaction of deemed ownership under division 240 of the Income Tax Assessment Act 1997 with "holding" rules and Division 40; T D 94/20; TD 93/142; I T 2594; IT 2395; IT2354; IT2287; IT2051; IT196; IT28.

² *FCT v Citibank Ltd* (1993) 26 ATR 423-luxury car leases;

³ *Granby Pty Ltd v FCT* (1985) 30 ATR 400.

⁴ *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 and *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497-both cases involving sale and leaseback of a fixture rather than borrowing against the security of assets.

⁵ See footnote 3

⁶ See generally Professor Roy Goode *Commercial Law* Third Edition Penguin 2004 chapter 28

⁷ *FCT v Citibank Ltd* (1993) 26 ATR 423 per Justice Hill.

holder who depreciates. The rental payments would be split up into principal and interest and there would be no double use of capital allowances.

I ACCOUNTING POSITION UP UNTIL 2005

AASB⁸ Standards 1008 defined operating and finance leases.

Paragraph 20.1 defined a finance lease as 'A lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred.'

Paragraph 5.3.4 describes a finance lease as one which is non-cancellable; and either the lease term is at least 75% of the economic life of the asset or the present value at the beginning of the lease of the payments exceeds 90% of the fair value of the asset at the start of the lease. In paragraph 5.3.1 we are told that the classification depends on its economic substance. The kinds of risks envisaged are obsolescence, idle capacity, fall in value and uninsured damage. Although there was a reference to the economic substance, in practice the 75% rule and that 90% rule were applied somewhat mechanically.

An operating lease was defined as 'A lease under which the lessor effectively retains substantially all the risks and benefits incident to the ownership of the leased asset.'

This is a definition that accorded with legal concepts. It recognized that ownership remained vested in the lessor and is likely to remain so given the absence of an option to purchase in the lease. The presence of an option would make it a hire purchase agreement thus necessitating the apportionment of the payments between principal and interest. According to the accounting standards, in the operating lease the lessee must recognise the rental expense in the financial year. The lessee has no asset and this is entirely in accordance with the legal form of the transaction.

II POSITION FROM ANNUAL REPORTING PERIODS BEGINNING ON OR AFTER 1 JANUARY 2005

A new approach was adopted in the 2005 standards which were made on 15 July 2004 though they applied to annual reporting periods beginning on or after 1 January 2005. These standards were adopted to give application to international standards. Under this approach there is a more clear emphasis on substance.

This is now contained in AASB 117. The definition of a finance lease is now more firmly based on economic substance and is found in definitions section 4:

"A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred."

"A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time".

"An operating lease is a lease other than a finance lease".

Paragraph 10 provides a number of criteria for deciding whether a lease is a finance lease. These include: whether the lease transfers ownership of the asset to the lessee at the end of the lease term, the presence of an option to purchase the assets at lower than a fair value at the end of the lease, the lease period is for a major part of the economic life of the asset, at the start of the lease the present value of the minimum lease payments represents substantially the value of the asset, and the assets are such of a specialised nature that only

⁸ Australian Accounting Standards Board. The Board's functions and powers are set out in the *Australian Securities and Investments Commission Act 2001*. Under s 296 of the *Corporations Act 2001* a company's financial report for the financial year must comply with accounting standards

the lessee could be expected to use them without major modifications. An example of assets being of a specialised nature would include sale and leaseback of a fixture where a third-party would not purchase the asset. Paragraph 10 provides that a finance lease is indicated where if the lease is cancelled the lessee will bear the gains or losses to the residual value at the end of the lease. Finance leases are also indicated where the lessee can at the end of the lease continue to use the asset for a rent that is substantially below the market value.

III LEGAL CHARACTERISATION OF THE LEASE

As far as legal characterisation⁹ is concerned, the lease of a chattel is a hire contract involving the bailment of a chattel from one person to another. It is not strictly speaking¹⁰ a lease. Although there is a distinction between a finance lease and an operating lease for the purpose of reporting accounts¹¹, at general law both types of leases are indistinguishable. If any question of insolvency arises the leased asset will belong to the lessor for the purposes of liquidation. Goode notes that although there is no significant legal distinction between an operating and a finance lease, operating leases tend to be used where the lessee does not require the use of the chattel for its effective life and the lessor will enter into a series of leases in respect of the chattel. The rental is fixed by reference to the asset's use value. In the finance lease the period of the lease tends to reflect the effective life of the asset. The rental instalments plus the residual value reflect the purchase price of the asset plus a reasonable return for the lessor. This payment is not unlike that which would be charged for a conditional sale of the asset. The assumption behind fixing of the rental payments is that the residual value of the chattel will be negligible at the end of the lease. In practice the Commissioner will not allow leases that do not have a residual value¹² for the asset at the end of the lease. Business persons look to the form of the agreement which in substance gives the lessee effective "ownership" though this would not be recognized by the general law. What is important is that the lessee has exclusive use and eventually will be the owner of the asset even though this is not provided for in the lease. Professor Roy Goode¹³ examines the commercial reasons why a lessee may prefer a finance lease to a conditional sale. In a finance lease the lessor is the owner¹⁴ and is therefore able to claim depreciation which enables it to pass on lower rental costs to the lessee. A second and less compelling reason according to Goode is that in a finance lease the lessee is not required to make a down payment as is usually standard in a conditional sale -- but there is no reason why this should be so in principle. Another historical reason was that liability under a finance lease did not have to be recorded on the balance sheet whereas a conditional sale would have to be capitalised as a liability on the balance sheet. This would enable the lessee's financial position to appear more liquid than it might otherwise be. Today the finance lease has to be recorded on the balance sheet¹⁵. AASB 117 paragraph 20 provides "At the commencement of the lease term, lessee shall recognize finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease".

⁹ Professor Roy Goode *Commercial Law* Third Edition Penguin 2004 chapter 28.

¹⁰ Hill J in *FCT v Citibank Ltd* (1993) 26 ATR 423 noted this distinction, though nothing turned on the difference in that case.

¹¹ These are given the force of law by *Corporations Act 2001* (Cth) Part 2M.3

¹² TR 2006/13.

¹³ Goode op. cit. at 722 -- 723

¹⁴ In Australia Division 40 of ITAA 1997 provides that the owner (lessor) in the circumstances is the holder and thus entitled to the depreciation.

¹⁵ AASB 117.

Hence it is also recognized as an asset of the lessee which gives it a more favourable appearance than a loan secured against corporate assets. Such a loan would only be a liability. In *Metal Manufactures Ltd v FCT*¹⁶ Emmett J at first instance said that using finance leases had the advantages of reducing after-tax financing costs, increasing reporting profits, improving cash flow and improving the balance sheet. An operating lease is not reported as a liability, but must be recognized as a "commitment". Paragraph 33 of AASB 117 provides "Lease payments under an operating lease shall be recognized as an expense on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit".

Paragraph 35 provides that other liabilities for the next year, next five years less one, later than five years also be recognized in the balance sheet. There is no corresponding asset in the lessee as there is in a finance lease. There may be some temptation to report a finance lease as an operating lease because of this favourable impact on the balance sheet. But the reporting of a lease as either finance¹⁷ or operating will have a more favourable appearance for reporting purposes than the simple recording of the transaction as a loan which is the alternative method of finance. Thus at the outset there are sound non-tax reasons for lease financing as opposed to borrowing against the security of assets. This reason does not seem to have been recognized by the ATO in former ruling TR 95/35 and current ruling TR 2006/13. Those reasons for preferring lease financing might be stated simply as: the impact on the balance sheet, the immediate cash flow given by sale and leaseback, the fact that the lessor is getting deductions for depreciation which may result in lower "interest/rent" payments by the lessee, and the lessee's purchase of the asset at residual value¹⁸. Such value is generally lower than market value and this means that although some of the recurrent lease payments result in the acquisition of a capital asset, this is not the sole or dominant reason from the lessor's perspective. The fixing of the residual value gives the lessee a real incentive to look after the asset during the currency¹⁹ of the lease, and a real incentive to purchase the asset at the end of the lease when the lessor/financier has no interest, reason or expertise to acquire the underlying asset.

IV PARTIES TO THE FINANCE LEASE

Generally there are three parties, namely the supplier, the end user (the lessee) and the financier (the lessor). Compared with the lessor, the lessee will have greater expertise as to its needs, the quality of the product, its cost and other characteristics. Once having chosen the particular plant the lessee may approach the financier who may purchase the asset from the supplier and then lease it to the lessee. More commonly the lessee may purchase the asset from the supplier and subsequently the contract will be discharged by novation so that the purchase contract will be between the supplier and the financier who will then lease the asset

¹⁶ (1999) 43 ATR 375 at 386.

¹⁷ Emmett J in *Metal Manufacturers Ltd* at 386 said " The State Bank provided a very comprehensive submission using a 37.5% residual value demonstrating that, assuming that the sale of the plant yielded \$55 million with a \$5 million up front fee to the State Bank, the company would save \$7.8 million over five years compared to a conventional loan of \$50 million. This represents an after tax interest rate of 5.68% per annum for the lease compared with 8.38% per annum after tax for a conventional loan". And see further at 388 where His Honour noted the favourable impact on the balance sheet of a sale and leaseback as compared to a loan.

¹⁸ In *Metal Manufacturers Ltd* the parties considered that a residual value of 10% would not be acceptable to the Commissioner, and a 37.5% residual value was used.

¹⁹ Per Lee J in *Granby Pty Ltd v FCT* (1985) 30 ATR 400 at 404.

to the lessee. Novation is necessary because it is only possible to assign benefits²⁰ and not burdens in contract law, though in some cases it may be possible to sever the benefits from the burdens²¹. In some cases the lessee may purchase an asset as agent on behalf of the financier who is an undisclosed principal. The recent capital gains tax case of *FCT v Sara Lee Household & Body Care (Australia) Pty Ltd*²² showed that it is possible to ratify a contract by a subsequent contract which varies the first contract but does not discharge it. Ratification will only be possible where the contracting party has contracted on behalf of a third-party though it will not be necessary to disclose that fact where the purchaser (lessee) contracts on behalf of the undisclosed principal. This will be unusual but not unheard of, so normally novation will be necessary, or alternatively the lessee might sell the asset to the financier and lease it back which procedure is also recognized in the rulings²³ and which in this case is not tax driven. Sale and leaseback in this context is perfectly legitimate, though sale and leaseback might take place many years after the taxpayer has acquired the relevant asset²⁴.

The standard finance lease in a taxation context does not give the lessee the right to purchase the asset nor does it oblige the lessee to purchase the asset because it is envisaged that the asset will have no value at the end of its effective life. As Goode²⁵ notes this expectation was not realised in the 1970s in a time of high inflation. Often the residual values could be quite significant even though they were below market, and the result was that a lessee who purchased the asset at the end of the lease at residual value could make a gain by its sale, though in Australia this would be in the case of a company an assessable capital gain with no discount²⁶ and there would be no discount for other taxpayers if the sale took place within a year. Alternatively the lessee may continue to use the asset for productive purposes after the lease period has expired or after having purchased it at residual value, and depreciating it from that cost. Where the lessee has sold the asset after acquisition at residual value, Division 40 of ITAA 1997 should not apply. Even though Division 40 now applies to depreciating assets, the lessee would not be the holder at the time of acquisition and provided the lessee does not use the asset for the gaining of assessable income after acquisition, there is no room for Division 40 to apply. Even though the gain was assessable in *Granby*, the taxpayer has still had the advantage of purchasing a capital asset with entirely deductible payments and has not been assessed until the end of the lease, and has still enjoyed the cheaper finance made available because the lessor has been able to depreciate the asset.

The taxation effect is that the financier/lessor is entitled to claim depreciation, while the lessee is making payments towards the acquisition of an asset which will eventually be purchased below its market value. This will result in an assessable capital gain on disposal of that asset, the gain being the difference between the residual value and the market value. In effect, though not in legal form, the lessee will have incurred revenue deductions in acquiring a capital asset, but the lessee will eventually be assessed on that gain. The only advantage in this form of structure seems to be the time value of money. The deductions are made during

²⁰ *Pacific Brands Sport & Leisure Pty Ltd and others v Underworks Pty Ltd* (2006) 149 FCR 395 at 404 paragraph 32 ; Meagher, Gummow & Lehane *Equity Doctrines & Remedies* Butterworth's Lexis Nexis 4th edition paragraph 6 -- 460; Greg Tolhurst *The Assignment of Contractual Rights* Hart Publishing 2006.

²¹ *Don King Productions Inc v Warren* [1999] 3 WLR 276 at 300-301, [2000] Ch 291.

²² (2000) 201 CLR 520 following *Tallerman Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd* (1957) 98 CLR 93 at 114 per Taylor J.

²³ TR to 3 Income Tax: sale and leasebacks.

²⁴ For Example, *Eastern Nitrogen Ltd v FCT* (2001) 43 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 43 ATR 497

²⁵ op. cit. chapter 28

²⁶ *Granby Pty Ltd v FCT* (1995) 30 ATR 400.

the currency of the lease whereas the assessment on the capital gain will only be made at the end of the lease. In economic but not legal effect there has been capital allowance on both sides of the transaction.

V BREACH OF CONTRACT BEFORE THE LEASE IS COMPLETED

Leases usually contain agreed damages clauses²⁷ in respect of executory obligations. The accounting standards²⁸ refer to the situation where the lessee cancels the lease and the lessor's losses associated with the cancellation are borne by the lessee. The advantage of such clauses is not merely that they simplify the work of the court, but that they permit summary judgement in the absence of a triable issue. In *O'Dea v All States Leasing System (WA) Pty Ltd*²⁹ such a clause was held to be invalid where the damages following default by the lessee were the entire outstanding rental undiscounted, the lessor being also entitled to retain the proceeds of sale even where they exceeded the residual value. In such a situation a court has to estimate the loss of bargain damages. The plaintiff is entitled to the damages which flowed naturally from the breach which were in contemplation of the parties at the time of contract under the first limb of *Hadley v Baxendale*³⁰. However, if the lessor chooses to terminate a lease under a provision in the lease for the lessee's conduct which does not constitute repudiation or breach of condition, the lessor's damages are confined to rental up to the date of breach³¹. Simply providing that a term is a condition³² or that its breach entitles the innocent party to terminate does not ensure that that term is a condition. Although the approach in *Shevill's* case has been doubted it rests on the logic that the plaintiff who terminates for minor breach has itself caused the loss of expectation damages and therefore the defendant should not be liable in the circumstances. The same rule applies in the UK³³. This means there will be problems in recognising the value of the lease.

VI COMMISSIONER'S ATTITUDE TOWARDS LEASE FINANCING

The ATO originally accepted the finance method of taxing leases but eventually came around to the operating method. It would be fair to say that the ATO has always been suspicious of lease financing, in particular in the context of sale and leaseback.

There are undoubtedly taxation advantages in lease financing but this does not mean that the taxation benefits are the dominant purpose of lease financing. The main advantage from the lessee's perspective is that the payments are entirely on revenue account and fully deductible. The Commissioner has sought to characterise certain lease financing as being in substance a

²⁷ Otherwise known as liquidated damages clauses where they are a genuine pre-estimate of the likely damage at the time of contract and thus do not constitute a penalty: *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 at 86. This is recognized in AASB 117 paragraph 11 (a) which provides "if the lessee can cancel the lease, the lessor's losses associated with the cancellation borne by the lessee".

²⁸ AASB 117 at paragraph 11.

²⁹ (1983) 152 CLR 359; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; *Esanda Finance Corp v Plessnig* (1989) 166 CLR 131; *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 at 86

³⁰ (1854) 156 E R 145

³¹ *Shevill v Builders Licensing Board* (1982) 149 CLR 620; *AMEV --UDC Finance Ltd v Austin* (1986) 162 CLR 170.

³² *Schuler (L) AG v Wickman Machine Tool Sales Ltd* [1974] AC 235, *Commonwealth of Australia v Amann Aviation Pty Ltd* (1991) 174 CLR 64

³³ *Lombard plc v Butterworth* [1987] QB 527 where the terms of the agreement made the breach repudiatory -- but had it not been so the liquidated damages clause would have been a penalty. *Financings Ltd v Baldock* [1963] 2 QB 104 at 110 gives a clearer example of the principle.

loan and therefore the payments should be split up into principal and revenue, and accordingly only part of the payment should be deductible. The first manifestation of this approach is to be found in former taxation ruling TR 95/30 which dealt with sale and leasebacks. As noted above there is generally nothing sinister about a sale and leaseback where the purchaser in effect has selected the chattels from the supplier and has then chosen to finance by means of sale and leaseback rather than novation of the contract. The position may well be different where the asset has been owned for a long time by the taxpayer who chooses to sell and lease back a fixture to a financier instead of borrowing against the security of the asset. Part of the advantage used to be that although there was a balancing charge on recouped depreciation, sale above original cost did not involve tax liability, or attracted the CGT regime. Accordingly the cost of the asset could be refreshed for the purposes of depreciation. Today any sale above adjusted value will result in the excess being assessable: section 40-285 of ITAA a 1997.

VII COMMISSIONER'S RULINGS

It is proposed now to analyse the Commissioner's ruling on sale and leaseback in 1995³⁴. The Commissioner made no distinction between the situation where the purchaser has acquired an asset and shortly thereafter has entered into a sale and leaseback with a financier, as opposed to the situation where the taxpayer has had the asset for several years and then decides to use sale and leaseback finance. In the typical leasing arrangement the purchaser has no right or obligation to acquire the asset at the end of the lease, though in practice this invariably happens and it is difficult to see the alternative purchaser where the asset is a fixture. Paragraph 3 of the ruling recognized the financing advantages of the sale and leaseback arrangement whereby the present value of the lease payments and the residual value is equal to the cost of the asset to the lessor (financier) and this provides an implicit rate of interest which is more favourable to the lessee (user) than ordinary interest rates. The Commissioner speculates that this may be partially attributable to the tax deductions available to the financier. Paragraph 8 of the ruling recognized that the payments will be deductible and these would generally be the same in an ordinary lease that did not exhibit the features of sale and leaseback.

In paragraph 10 the Commissioner refers to the sale values that are acceptable. One of these is market value under which the price must be "the price at which an asset can be bought and sold between a willing, arm's-length purchaser and vendor, both acting knowledgeably, prudently and without compulsion".

If no such market exists, the tax depreciated value is acceptable. Market value must be ascertained by independent valuation and the asset must be valued separately from its use in the business since this is the value it would realise should there be default by the lessee. All this sounds very convincing until one hears from practitioners³⁵ that market value can fluctuate wildly even on the stock market³⁶ on a given day, and as for arm's-length value this is a very difficult matter to pin down in practice. Most leases envisage the sale of assets at the end of the lease and in paragraph 12 the Commissioner accepts that although the residual value may be below market at the end of the lease, he will accept a genuine pre-estimate at the time of inception of the lease of the residual value as being market, provided there was independent evidence as to the value which was made bona fides.

³⁴ TR 95/30 Income Tax: sale and leasebacks. Now withdrawn and replaced by TR 2006/13.

³⁵ Eg . Michael Brown "*Modelling Tax Compliant Tasks for Large Businesses*" Australian Tax Research Foundation Executing Australia's Income Tax 19 October 2006 Sydney.

³⁶ E.g. in the crash of 1987 NewsCorp Ltd shares fell from \$24 to \$14 on one day.

In paragraph 14 the Commissioner said that he would not accept sham³⁷ transactions where the documents do not reflect the true intention of the parties. He seems to have in mind that sale and leaseback might in reality reflect a loan transaction. In paragraphs 16 and 17 he dealt with sale and leaseback of a fixture which he denied was legally possible. The issue still remains unresolved at law though Professor Butt³⁸ sees no reason in principle as to why a legal holder could not dispose of a part legal interest in the land such as a fixture whilst retaining underlying ownership of the land. The Commissioner states that where the purchaser (financier) gains only a contractual interest in the asset whilst the user retains possession of the fixture, there will not be a valid sale and leaseback. However, the full Federal Court in *FCT v Metal Manufacturers Ltd*³⁹ has left open the question whether such arrangements will vest sufficient equitable title in a financier to enable the financier to gain depreciation, but concluded that the user can claim deductions for use of the asset. The sale and leaseback will provide for an equitable title in the financier that will empower the financier in the event of default to enter the land and take possession of the fixture. This is clearly more than a contractual right and was accepted as such by the Commissioner⁴⁰ before the full Federal Court in the *Metal Manufacturers case*. Indeed the matter was not contested in the application for special leave⁴¹ to the High Court.

In paragraph 18 of the ruling it was stated that the presence of an option or other legal right in the lease would mean that part of the lease payments were on capital account. It is of course standard procedure to state in the lease that there is no option or obligation to purchase -- see for example *Eastern Nitrogen Ltd v FCT*⁴². Since the asset is invariably purchased by the lessee at the end of the lease the Commissioner submitted in a special leave application before the High court in *Metal Manufacturers Ltd* that the substance⁴³ of the agreement was that the lessee would purchase the asset at the end of the lease. The full Federal Court

³⁷ *Snook v London and West Riding Investments* [1967] 2 QB 786. See more recently *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* (2004) 218 CLR 471, *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 82 ALR 530, *Scott v Commissioner of Taxation (no 2)* 40 ALJR 265, *Ascot Investments Pty Ltd v Harper and Harper* (1981) 148 CLR 377, *Gould and Gould; Swire Investments Ltd* (1993) FLC 92-434.

³⁸ Butt (2000) 74ALJ 130. In *Eastern Nitrogen Ltd v FCT* 46 ATR at 484 Carr J left open the possibility that the financier would gain a legal title in the fixture saying "It may well be that the Instalment Purchase Agreement was effective at common law to pass property in the ammonia plant to the financiers, even though it was a fixture and part of the land owned by the appellant..... The subject is discussed by Mr Peter Butt in a note "Conveyancing and Property" (2000) 74 ALJ 130. I do not see anything in the authorities discussed in that note which would prevent ownership of the ammonia plant passing at common law to the financiers under the Instalment Purchase Agreement. What the appellant contracted to sell, and may well have sold, to the financiers was no mere "bundle of rights" [*Melluish v MBI (No 3) Ltd* [1996] 1 AC 454 at 475], it was full legal and beneficial ownership".

³⁹ (2001) 46 ATR 497 considering *Kay's Leasing Corporation Pty Ltd v CSR Provident Fund Nominees Pty Ltd* [1962] VR 429. The full court adopted the approach of Emmett J at first instance *Metal Manufacturers Ltd v FCT* (1999) 43 ATR 375. Emmett J also relied on *re Samuel Allen & Sons Ltd* [1907] 1 Ch 575, and *Melluish v BMI (no 3) Ltd* [1996] 1 AC 454 at 475 -- 476. See also *Re Morrison, Jones & Taylor Ltd* [1914] 1 Ch 50 at 54 -- 55, 58 and 60 -- 61 cited with approval by Carr J in the full Federal Court in *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 at 484.

⁴⁰ See Sundberg J in *Metal Manufacturers Ltd* at 510 paragraph 57 "Before the primary judge the Commissioner argued that because the plant and equipment were fixtures the instruments were ineffective to achieve their stated objects. The contention was not repeated on the appeal, and it was not suggested that his Honour's conclusion that while the Bank acquired no legal interest, it did obtain an equitable interest, was erroneous". His honour left open the question raised by Professor Butt as to whether the financier could acquire a legal title.

⁴¹ Special leave was refused by the High Court in the *Metal Manufacturers case* and in *Eastern Nitrogen Ltd* which matters were heard together on 15th February 2002. Transcript of argument at Austlii.

⁴² (2001) 46 ATR 474 at 483 paragraph 41.

⁴³ Section 177D (b) (ii) requires the court to have regard to "the form and substance of the scheme".

rejected this argument and the High Court would not allow special leave on the basis of it. In paragraph 19 the Commissioner sought to extend this proposition by saying that part of the payments would be capital where the residual value of the asset was less than market value or the lease was for the whole of the useful life of the asset. Needless to say neither proposition has been accepted by the case law and in paragraph 42 the Commissioner relied on *Mills v Stokman*⁴⁴ as authority for the proposition that a fixture cannot be sold separately from the land. Yet that case only decided that there was no sale of goods where there is no agreement to sever the relevant asset and therefore a contract for the removal of slate was a *profit a prendre* which was unenforceable because the requirement for writing or registration⁴⁵ which created an interest in land was not satisfied. The case is certainly not authority for the proposition that a fixture cannot be sold separately from the land. Indeed the Commissioner concedes in paragraph 45 that it may be possible to create an equitable interest in the financier in such circumstances.

In paragraph 20 the Commissioner discusses leveraged leases, but there is nothing exceptional about these where the end user is a taxpayer. The financier/lessor has simply borrowed money to enable more business to be done which is common enough in commerce. This does have the effect of increasing the cost base for the lessor's depreciation, but there has never been a requirement that the lessor must have 100% equity in the cost of an asset before being able to depreciate it using its acquisition cost.

In paragraphs 21 to 27 the Commissioner considers the application of Part IVA but this has subsequently been dealt with extensively in case law⁴⁶. The Commissioner does not seem satisfied with the case law with respect to the sale and leaseback of fixtures. He has sought to characterise these as disguised loans where repayments should be broken up into principal and interest. So far he has not been successful.

VIII TAXATION RULING TR 2006/13

The Commissioner has revisited the issue in 2006. Although the ATO accepts the lease arrangement where the precedents of the full Federal Court in *Eastern Nitrogen Ltd* and *Metal Manufacturers Ltd* have been followed, any variation from that approach will likely be treated as a loan arrangement and apportionment will be made between principal and interest. It seems a rather futile distinction given the Commissioner's⁴⁷ unequivocal acceptance of these two cases. It is proposed to analyse the propositions in the ruling.

In paragraph 2 of the ruling it is stated that an agreement which purports to be a sale and leaseback may not be so having regard to the legal rights and obligations conferred on the parties. In paragraph 5 the Commissioner concedes that the requirements of sale and leaseback will be satisfied where there is an equitable interest vested in the lessor (financier). In paragraph 7 it is said that the presence of an option or obligation which will vest the asset in the lessee at the end of the lease will take the transaction outside the ordinary operation of leases. This is an obvious proposition but the taxpayer is always at pains to ensure that there is no obligation or option in the contractual documents. In paragraph 9 it is asserted that the transaction is similar to a loan, but however this may be, there is no room for economic equivalence in the field of taxation law. A transaction must be characterised by the legal

⁴⁴ (1967) 116 CLR 61; same approach maintained in TR 2006/13 paragraph 57.

⁴⁵ There was a contract for the sale of slate which was lying on land part of which was old system and another part was Torrens system. It is even questionable whether slate laying on land can be described as a fixture.

⁴⁶ *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497.

⁴⁷ TR 2006/13 paragraphs 25 and 33. The Commissioner sets out criteria for tax avoidance in paragraph 37.

form in which it is clothed. This is a proposition which the Commissioner⁴⁸ recognizes later in the ruling.

The Commissioner then addresses the issue⁴⁹ of who is the holder of the asset for the purposes of Division 40 of ITAA 1997. In a sale and leaseback the sequence is as follows: the lessee sells the depreciating asset to the lessor who becomes the holder under item 6 of section 40-40. The parties then enter into a leaseback arrangement, the lessor losing the right to possess and therefore ceasing to be the holder under item 6. The lessor now holds the asset under item 4 because it is the lessor of a fixture with the right to enter and recover the asset in certain circumstances. The lessee also is a holder with a nil cost base and therefore its interest can be ignored for depreciation purposes. The Commissioner will accept a residual value⁵⁰ where there is a genuine pre-estimate of market value made at the time of entry into the lease. The valuation must be bona fide and based on independent evidence and be no lower than that set in Taxation Ruling IT 28 and taxation determination TD 93/142 and termination value will be determined in accordance with sections 40-300 or 40-305 of ITAA 1997.

In paragraphs 25 to 36 the Commissioner deals with assets that are fixtures. It is asserted that the owner of land cannot generally sell a fixture without its being removed from the land. No authority is cited for this proposition and it has been contested⁵¹ by Professor Butt. Such a possibility was not ruled out by the full Federal Court in *Eastern Nitrogen Ltd* and in *Metal Manufacturers Ltd*, but the decisions were actually based on the lessor/financier having sufficient equitable title to justify the lessees' paying of rent. There is no clear authority⁵² as to whether such equitable title would be sufficient to justify the claiming of depreciation as a holder under section 40-40. At paragraph 62, after conceding that the full Federal Court decision in *Eastern Nitrogen* was correct, the Commissioner concluded that the court did not consider whether the lessor's (equitable) proprietary right was sufficient to constitute "ownership" under s 54 of the 1936 Act which was then applicable. The Commissioner envisages that there may be dual ownership under the current provisions. This is because the lessor/financier has an equitable interest in the fixture together with a right to remove in certain circumstances, which is sufficient to constitute a holding under section 40-40 item 4. The lessee may also be a holder as legal owner under section 40-40 item 10 though in this context the lessee has sold the asset and has either been assessable on a balancing charge, or gained a deduction under a balancing deduction, and would have a cost of zero. It seems the only sensible outcome is that the equitable owner/lessor/financier should claim the depreciation as the holder.

The Commissioner has sought throughout the ruling to characterise sale and leaseback as a disguised loan. In economic substance it may well be a loan and this is the approach under the accounting standards AASB 117 when a finance lease is said to be in economic substance similar to a loan, though accounting standards for reporting purposes cannot govern the substantial legal issues in this context.

AASB 117 Paragraph 10 provides:

⁴⁸ *ANZ Savings Bank Ltd v FCT* (1993) 25 ATR 369 at 391 -- 392 per Hill J at paragraph 79 and 81 of the ruling.

⁴⁹ Paragraphs 27, 28 and 29.

⁵⁰ Paragraphs 80 (C), 87 and 95 (a).

⁵¹ Butt (2000) 74 ALJ 130 where he said there was no reason in principle why an owner could not at common law dispose of fixtures separately, since an owner was entitled dispose of part of an interest at law. See further the comments in footnote 37, and the comments of Carr J in *Eastern Nitrogen* supra.

⁵² Paragraph 72 of the ruling referring to *Bellinz Pty Ltd v FCT* and see also *Melluish (Inspector of Taxes) v BMI (no 3)* [1996] 1 AC 454.

“Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.”

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

IX LEASES IN TAXATION LAW - FEDERAL COURT

Up until 1 July 1990 the ATO allowed taxpayers to derive their income in accordance with the finance method under rulings IT 2162 and IT 2166. These rulings were withdrawn from 1 July 1990 under ruling IT 2594. Subsequently the courts indicated that in taxation law they will only accept the operating lease as giving a substantially true reflex of the lessor's income⁵³. In *FCT v Citibank Ltd*⁵⁴ the taxpayer was a banker who also leased motor vehicles in return for rental. Hill J described this as chattel leasing though it could be more correctly described as a bailment⁵⁵ for a series of payments. Nothing turned on the distinction in that case. Section 57 AF⁵⁶ of ITAA 1936 (Cth) placed a limit on the cost price of luxury cars for the purposes of depreciation. Before this limit it would make no difference to the income of the taxpayer whether the assessable income was calculated by treating the transactions as operating leases or financing leases.

If the transaction was treated as a finance lease the lessee is regarded as effectively having substantially all of the risks and benefits of ownership. The lessor is regarded as having an asset equal to its investment at the commencement of the transaction and then apports the

⁵³ The right to claim capital allowance (depreciation) in Div 40 of ITAA now belongs to the "holder" who is generally the legal owner but more generally the person who suffers economic loss from the decline in value of the asset. In the case of a luxury car the holder is the lessee, which seems to follow the pattern of the finance lease. In the event of liquidation the asset would be the property of the lessor.

⁵⁴ (1993) 26 ATR 423

⁵⁵ A similar issue of characterisation of a fixture in sale and leaseback arose in *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 where there was sale and leaseback of a fixture which the parties sought to characterise as goods and which probably remained an interest in land. If it were an interest in goods and the law bailment would apply, if it were an interest in land then the law of leasing would apply. Carr J said at pp 484 --5 paragraph 50 "in my opinion the Instalment Purchase Agreement and the Agreement for Lease were effective to create an equitable interest in the ammonia plant, in the nature of property, in the financiers, which was sufficient to support the "leasing" by the financiers of the ammonia plant to the appellant and the "taking on lease" of the ammonia plant by the appellant. I shall, as a matter of convenience, use in these reasons the language of real property leasing (which seems appropriate given that it is common ground that the ammonia plant was a fixture) although the parties thought that they were dealing with personalty to which bailment principles were more appropriate".

⁵⁶ Now section 40 -- 230 of ITAA 1997 which for the year ended 2008 is \$57,123. Under section 40-40 item 1 it is now the lessee of a luxury car who is regarded as the holder and therefore the person entitled to depreciation and the Div 40 of ITAA 1997. Depreciation is now referred to as capital allowance under Div 40.

rental payments between principal and interest.⁵⁷ This may be the correct method for reporting company accounts⁵⁸, but in the taxation context the approach is different. Under income tax law gross amounts are assessable income and from these are deducted amounts allowed under the statute to give a net figure described as taxable income⁵⁹. Income tax law will characterise a net amount as assessable income in exceptional circumstances, but only where the gross amount is not income. Examples where this has occurred include switching by insurance companies⁶⁰, where Australian courts adopted English precedent which was based on a system that taxed profit.

Under the leases in the *Citibank* case, the lessor retained title to the plant and received a series of payments in respect of that plant. Those gross amounts could be described as rental and could not be distinguished from the situation of landlord and tenant where the gross rental is assessable income and the landlord has deductions for depreciation and repairs. Under a standard chattel lease the lessor leases the asset for several years, and the lease provides that the asset will be sold at the end of the lease for a residual value. If at the end of the lease the asset is sold below residual value, the lessee must pay the difference to the lessor, though this payment will be deductible as part of the lease⁶¹. Typically the residual value is in fact below the market value at the end of the lease. In *Granby Pty Ltd v FCT*⁶² Lee J said that residual values were below estimated market values at the end of the lease so that lessor corporations could safeguard the capital they, as financiers, invested in their chattel purchase and lease transactions. The setting of residual values at below market at the end of the lease was as an inducement to the lessee to care for the property. In *Austin v United Dominions Corp*, Priestley AJ said⁶³

The commercial practice of lessors of chattels whereby their rental charges and residual values are so calculated that if a leasing agreement runs its full course and on its conclusion the lessee buys the chattel from the lessor (there having been no pre-existing obligation upon the lessor to sell if requested) the lessor will have been reimbursed by the receipt of the rental instalments and the residual value for the capital laid out on the

⁵⁷ Under *Citibank's* standard lease the lessee promised to pay the instalments of rent notwithstanding any damage or defects in the goods, the lessee had no right of purchase being only a bailee. The goods were to be maintained by the bailee and were at the risk of the bailee who also had to take out insurance. At the end of the lease the goods were to be sold, and if below residual value the lessee had to pay the difference. The effect of this was that the lessor derived a calculable return. This meant that in terms of company accounting there was finance lease.

⁵⁸ *FCT v Citibank* (supra) at 433 adopting the expert evidence of Professor R Walker, then a Professor of Accounting of University New South Wales: at 429. Certainly on liquidation the courts will not look to 'the economic substance of the matter.' Formal legal ownership of assets is important here, and in terms of legal principles it difficult to understand why a finance lease should be treated as an asset of the lessee when it will not be available to the lessee's creditors in the event of liquidation. Where an entity has made a loan the principal is an asset but the loan contract is not a separate asset though it is a chose in action: *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 at 217 – 218. Since this property right is not recognised as a separate asset, it is difficult to see why the lease should be.

⁵⁹ ITAA 1997 sections 4-15, 6-(5), 6 -(10),8-1.

⁶⁰ *Colonial Mutual Life Assurance Society Ltd v FCT* (1946) 73 CLR 604; *Australasian Catholic Assurance Company Ltd v FCT* (1959) 100 CLR 502; *Chamber of Manufactures Insurance Ltd v FCT* (1984) 15 ATR 599; *FCT v Employers Mutual Indemnity Association Ltd* (1990); *FCT v Employers Mutual Indemnity Association Ltd* (1990) 21 ATR 741. Investment companies where their holding of shares are not trading stock: *London Australia Investment Company Ltd v FCT* (1977) 138 CLR 106. Exchange gains and losses where the moneys advanced are capital : *Avco Financial Services Pty Ltd v FCT* (1982) 150 CLR 510. Profit-making schemes: e.g. *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR 355.

⁶¹ TR 2006/13.

⁶² (1985) 30 ATR 400 and 404.

⁶³ In *Austin v United Dominions Corp Ltd* (1984) 2 NSW LR 612 at 623 -- 624 Priestley AJ

chattel and commercial rates of interest on that sum for the period of the lease, in a way analogous to that in which it is finally reimbursed at the conclusion of a hire purchase agreement. Thus, in a leasing transaction of this kind the residual value will be a balancing figure which, when added to the rental instalments, will produce a figure equal to a return of the lessor's capital plus the desired return of interest over the period for the outlay of its capital. It will thus bear no necessary relation to the market value of the chattel at the end of the lease, although presumably the lessor would tend to calculate it at a lower figure than market value (difficult though this might be to predict in regard to some types of chattel) to ensure that if the lessee did not indicate any wish to buy it at the end of the term it could then be sold without detriment to the lessor's original calculations. In some cases this approach would require the rental payments to be at a higher rate than what would be the market rate for the rental of goods which was to be expected to be returned to the owner at the end of the lease. In a lease arrangement this kind, a lessor needs some provision in the lease agreement to bring about the result, when the agreement is terminated mid-term, that the lessor will be in the position of recovering its capital together with the calculated rate of interest for the shortened term.

In other words the lessor sets the lease payments and the residual value in such a way as to guarantee a particular return. If the leases terminated before its agreed term there will be a liquidated damages clause to compensate the lessor. If at the end of the lease the lessee was able⁶⁴ to purchase the asset at below market value this was no concern of the lessor who had received its expected return. Although the arrangement has tax advantages there are substantial commercial reasons for using leases instead of loans, and the pitching of residual value is allegedly not tax driven.

From the lessee's perspective, the lease payments were entirely on revenue account since the lease itself gave the lessee no right to purchase the asset at the end of the lease. It is invariably the practice⁶⁵ for the lessee to purchase the assets at the residual value, thus in commercial effect giving the lessee the ability to deduct part of the purchase price. But such payments cannot be characterised as capital when viewed from a legal perspective because the leases themselves contain no option to purchase, and the law does not look at 'the economic substance of the matter'⁶⁶ but is more concerned with form i.e. who owns the asset. As stated by Hill J in distinguishing between a loan and an annuity in *ANZ Savings Bank Ltd v FCT*,⁶⁷

What must be determined in the present case is whether the transaction into which the parties have entered is a loan involving the repayment of a principal sum with interest, or whether it is a contract for an annuity, or a contract for insurance. In the absence of a submission that the transaction entered into by the parties is a sham, a disguise for some other and different transaction, and in the absence of the application of the anti-avoidance provisions of Part IVA of the Act, the court must look to see what the transaction entered into by the parties by its terms effects. That is to say, regard must be had to the legal rights which the transaction actually entered into confers. Invocation of the doctrine of substance is of no assistance in this task.

⁶⁴ The lessee had no right under the lease to purchase the asset though this is what invariably happens. In effect the lessee is able to purchase an asset considerably below its market value at the end of the lease. In commercial effect it is getting a deduction for what is the purchase price of an asset and therefore analogous to capital. Since the lessee has no right to purchase the asset under the lease, the entire lease payments are regarded as revenue and hence deductible at the time of payment: *South Australian Battery Makers Pty Ltd v FCT* (1978) 8 ATR 879.

⁶⁵ The practice would seem to be inevitable with the relevant asset is a fixture subject to sale and leaseback.

⁶⁶ *Europa Oil (NZ) Ltd v IRC (NZ) (No 1)* (1970) 1 ATR 737 at 744 'Taxation by end result, or by economic equivalence, is not what the section achieves.' *Europa Oil (NZ) Ltd v IRC (No 2)* (1976) 5 ATR 744 at 750 'it is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.' Courts do not look to economic benefits and 'the reference to "reality" was directed only to the legal character of the payment and not to its economic consequences.'

⁶⁷ (1993) 25 ATR 369 at 391 -- 392.

The current position with luxury cars is that the rental is fully deductible at the time of payment, and the lessee will depreciate but will not be able to use the cost above that set by ITAA 1997. Had option 2 under the Ralph Report been adopted so that tax accounting would follow ordinary accounting, the finance lease may have found its way into tax jurisprudence. A similar attempt to bring finance leases within TOFA was abandoned in the May budget of 2007.

The Commissioner's ruling indicates that the ATO is not entirely happy with the sale and leaseback of fixtures and would like the opportunity characterise such transactions as disguised loans. However, a loan involves the advance of a sum of money from a creditor to a debtor and the debtor undertakes to repay the principal sum together with interest if applicable. The courts though must look to the legal rights conferred by the contracts. Sale and leaseback could not fall within this characterisation. In rejecting such an approach Carr J⁶⁸ said

I accept the appellant's submissions that although the overall arrangement was a financing arrangement, it did not involve a loan. There was no obligation to repay a sum advanced. The authorities recognise that arrangements can be made for financial accommodation without a loan being involved: *Chow Yoong Hong v Choong Fah Rubber Manufactory*⁶⁹; *Prime Wheat Association Ltd v Chief Comr of Stamp Duties*⁷⁰; *ANZ v FCT*⁷¹; *N M Superannuation Pty Ltd v Young*⁷².

X CONCLUSION

The only distinction between an operating and a finance lease is in respect of the reporting requirements which have the sanction of law under the *Corporations Act* (2001). The Commissioner does not seem to be satisfied with the outcome of leasing cases involving the sale and leaseback of a fixture⁷³. He has sought in the past to characterise such arrangements as being disguised loans, but this is simply not possible given the nature of a loan. If finance leases are to be treated as loans for taxation purposes, legislation will be necessary to achieve this result. In the absence of such legislation Part IVA will not prevent standard leasing arrangements because there are sound reasons why commercial persons would choose to finance their business by means of leasing rather than borrowing against secured assets. These reasons are mainly concerned with the reporting requirements whereby the finance lease leaves a far better impression in the balance sheet than a simple loan. It involves the recognition of a liability, but the leased property is regarded as being an asset of the lessee and no such concession is possible where there is a simple loan. This factor was referred to by Emmett J in *Metal Manufacturers Ltd v FCT*⁷⁴ but has not been recognized by the Commissioner in the ruling TR 2006/13. There is a tax advantage in lease financing. This occurs because the lessor/financier being the holder depreciates the asset whilst the lessee is in commercial effect purchasing the asset through the lease payments which are entirely on revenue account. It is an invariable practice that the lessee purchases the asset at the end of the lease for a residual value below market. In economic effect the asset is being depreciated on both sides of the transaction, but this is not the legal effect of the documents. Arguments

⁶⁸ *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR at 485 Paragraph 54.

⁶⁹ [1962] AC 209 at 216 -- 217.

⁷⁰ (1997) 42 NSWLR 505 at 511 -- 12; 37 ATR 479 at 483 -- 84; 97 ATC 5015 at 5019.

⁷¹ (1993) 42 FCR 535 at 360; 25 ATR 369 at 391 -- 92; 93 ATC 4370 at 4389.

⁷² (1993) 41 FCR 182 at 199 -- 201.

⁷³ TR 2006/13 at paragraph 37

⁷⁴ (1999) 43 ATR 375 at 386 -- 387.

as to substance had been rejected by the full Federal Court⁷⁵ and by the High Court⁷⁶ in rejecting an application for special leave in those cases.

Leasing is commonly and widely used, and though it cannot be denied that there are tax advantages, lease financing is not undertaken with the dominant purpose of gaining a tax benefit, and if the Commissioner wishes to address the problem of lease financing then it must be done by specific legislation. In this regard lease financing shares a common characteristic with the discretionary trust.

⁷⁵ *Metal Manufacturers Ltd, Eastern Nitrogen Ltd* (supra).

⁷⁶ McHugh and Gaudron JJ.

PARTNERS OR COMBATANTS: A COMMENT ON THE AUSTRALIAN TAX OFFICE'S VIEW OF ITS RELATIONSHIP WITH THE TAX ADVISING PROFESSION

JUSTIN DABNER*

The approach to administration of the Australian tax system has, over time, fluctuated between an adversarial and a co-operative approach. Currently, consistent with a move to a responsive regulatory strategy, the Australian Tax Office ("ATO") has expressed its desire for a co-operative partnership style relationship with the tax advising profession. The profession is seen, in its view, as a critical leverage point to promote voluntary compliance with the tax system by the bulk of taxpayers.

The advent of a partnership style relationship between the ATO and the tax profession raises many issues, primary of which is whether the desire to establish this relationship is mere rhetoric employed by both parties in the pursuit of their divergent interests. In fact, the very existence of these opposing interests raises the possibility of ethical conflicts that need to be carefully managed by both parties to the partnership.

The ATO is to be commended for the humane and practical way in which the evidence in this case shows its officers dealt with persons who are in difficulties. That attitude indeed probably produces more actual cash into the Treasury than any other approach. It will occur from time to time that some taxpayer will abuse that approach. It may also be that the laws ... nowadays operate unfairly against the ATO. I hope that neither of these last two points will operate to change the general attitude.

Justice Young in *Dean-Willcocks v FCT* (2004) NSWSC 1058 (10 November 2004) at para 88.

I INTRODUCTION

The 20th century has been described as a "great century for tax collection".¹ As the economic rewards of increasingly sophisticated technological societies have expanded together with the development of a greater social conscience governments have increasingly turned towards taxation as a means to fund social programs and public goods. The design of tax systems themselves have often been employed as a means to deliver social equity through the medium of tax expenditure programs. Furthermore, the increasing sophistication of modern commerce has meant that these tax systems have had to be able to respond to many and varied scenarios and transactions.

The result of this confluence of factors is that tax systems have become incredibly complex. Furthermore, the increasing size of the tax impost has presented a significant incentive for taxpayers to avoid their obligations. Thus the role of the tax collection authority has become increasingly important and, indeed, difficult.

Tax authorities around the world have approached the administration of their tax systems from the perspective that voluntary compliance is the linchpin of the success of the system. However the complexity of these systems has rendered it almost impossible for the average taxpayer to identify their tax liability and obligations. This

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¹ Attributed to Professor Christopher Hood in John Braithwaite, *Markets in Vice Markets in virtue*, The Federation Press 2005 at 18 ("Braithwaite 2005").

has led to the development of a new breed of financial and business adviser known as the tax advising professional.

The scope of the tax advising profession extends from tax preparers or agents at one extreme, who assist simple taxpayers to prepare their tax returns, through to highly qualified accountants and lawyers who assist large multinational companies to minimize their tax liabilities and contest disputes with the tax authority.

Tax authorities recognize that courting this new tax advising industry is critical to achieving their tax compliance goals. Certainly the evidence in Australia is that the significance of the tax advising profession has increased markedly with the advent of the self assessment system and the profession is considered as a key compliance leverage point to influence taxpayer behaviour.²

The response of the Australian Taxation Office (“ATO”) has been to avow that its relationship with the profession is one of a partnership. This is consistent with modern regulatory trends. However it will be suggested in this paper that if this label is accurate it raises many issues that need to be resolved. In particular issues as to conflicts of interest, transparency and accountability and the application of the partnership model need to be addressed.

II REGULATORY THEORY AND TAX ADMINISTRATION

The different approaches to tax administration borrow from general regulatory theory. Regulatory theory traditionally has distinguished between the compliance approach and the deterrence or sanctioning approach.³ The compliance approach describes a co-operative problem solving approach in an ongoing working relationship between the regulator and the regulatees. Conformity, or near conformity, with regulatory requirements is intended to be achieved with sanctions as a last resort.

The deterrence approach, on the other hand, describes a regulatory style in which the regulator demands that the regulatory requirements are met or sanctions will be imposed.

These two approaches are best viewed as extremes of a continuum and real-world regulation involves a mix of the two with any particular regulator fluctuating between the two ends of the continuum depending on the current mindset derived from the political and socio-economic conditions of the time.⁴

This mix can also be reflected in what is commonly described as “responsive regulation” whereby a regulator’s response to a regulatee’s most recent conduct will be determined by the characteristics of the regulatee.⁵ So co-operative regulatees are responded to co-operatively and recalcitrant ones in a punitive manner. Theory

² Australian National Audit Office, *The Auditor-General Audit Report No 19 2002-03 Performance Audit: The Australian Taxation Office’s management of its relationship with tax practitioners* at 38-39 and 40. The profession would appear to have the ability to exert either a positive or negative influence on tax compliance. Higher qualified professionals tend to have a more negative effect on taxpayer compliance than lower end advisers: Maryann Richardson and Adrian Sawyer, “A taxonomy of the tax compliance literature: further findings, problems and prospects” (2001) 16 *Australian Tax Forum* 137 at 208 – 212.

³ K Hawkins, *Environment and enforcement: regulation and the social definition of pollution*, Oxford University Press, Oxford 1984 and A Reiss Jr, “Selecting strategies of social control over organisational life” in K Hawkins et al, *Enforcing regulation*, Kluwer-Nijhoff publishing, The Hague, 1984.

⁴ Ibid.

⁵ John Braithwaite, *Restorative justice and responsive regulation*, especially chapter 2 “Responsive regulation” at 29 – 44, Oxford University Press, Oxford 2002.

supporting responsive regulation points to an enforcement pyramid, that is escalating steps directed at establishing compliance where interaction between the regulator and most regulatees will occur at the base of the pyramid representing co-operative measures. Non-co-operative regulatees will be met with increasingly punitive measures as they move up the pyramid.⁶

Recent “smart regulation” theories recognize that a regulator and regulatees operate in an environment where there are other regulatory stakeholders. The regulator can leverage off these stakeholders to more effectively achieve its compliance goals.⁷ Thus, for example, a tax administrator, in the pursuit of mandating compliance with the tax laws, might leverage off the need for company directors to comply with their corporate law obligations to shareholders and the corporate law regulator.

In the context of tax administration the deterrence theory translates into an adversarial relationship between the administrator and taxpayers and their advisers akin to the relationship between opposing counsel in a common-law system. Under this model the tax authority would administer and apply the law with a view to maximizing government revenue and pursuing government policy whilst the profession would seek to minimize the tax liabilities of its clients by employing tax planning techniques and / or asserting pro-taxpayer interpretations of the tax law.

At the other extreme, the co-operative approach, the tax authority and the tax profession might form a partnership with a view to minimizing conflict and seeking to achieve negotiated positions. Such an approach might be justified by the tax authority on the basis of the administrative cost savings and efficiency notwithstanding a possible loss of some tax revenue.⁸ Similarly the profession might justify such an approach for their clients on the basis of a compromise between the costs of a possible dispute with the tax authority and the desire to minimize tax payable. Notably, there appears to be no research as to which approach returns the best tax compliance dividend.

This co-operative approach is premised on the tax authority engaging with the community and being responsive to its concerns whilst being wary not to simply appease special interest groups at the expense of system integrity.⁹ As is discussed below, this raises the twin issues of as to whom in the community the authority should listen and how is it to filter what is put to it to maintain system integrity. In the particular context of engaging with tax practitioners it will be suggested that the profession is eclectic in nature and it can be expected that some members are very adept at negotiating an agenda for specific interest groups in the guise of more innocent concerns.

The regulatory history of the ATO reflects the various regulatory theories with the organization having fluctuated between the two extremes of compliance and deterrence within a command and control framework of regulation.¹⁰ Its approach might now be

⁶ Ibid.

⁷ N Gunningham, P Grabosky and D Sinclair, *Smart regulation: designing environmental policy*, Oxford University Press, Oxford, 1998.

⁸ However some would suggest that the more conciliatory approach adopted by the ATO in recent years has and will continue to lead to greater tax revenues: “Carmody’s softly softly approach delivers windfall” *Sydney Morning Herald* (27 June 2006) 36.

⁹ Valerie Braithwaite, “Chapter 13 - Tax system integrity and compliance: the democratic management of the tax system” in *Taxing Democracy: Understanding tax avoidance and tax evasion*, Ashgate, Aldershot, 2003 at 269.

¹⁰ Cynthia Coleman and Margaret McKerchar, “The chicken or the egg?: A historical review of the influence of tax administration on the development of income tax law in Australia” in John Tiley (ed) *Studies in the history of tax law*, Hart Publishing 2004 at 285. The tax administration and tax professionals during the 1950s enjoyed a co-operative relationship. The ATO’s recent approach would

described as firmly embedded in responsive regulation with its compliance pyramid approach. The ATO's hierarchy, at least, see a co-operative approach to taxpayers as the dominant approach,¹¹ consistent with what appears to be an international trend.¹² This has been expressed by the ATO as a desire to more fully establish a partnership approach with the profession.¹³ This is indeed part of a larger tax compliance strategy that the ATO has embraced. This strategy seeks to found the collection of tax revenue in the principle of voluntary compliance whilst identifying risk areas where ATO enforcement resources can be more efficiently focused. The move to this strategy was necessary as the ATO's pursuit of efficiency in the face of an increasingly complex tax system required a change from a manual return processing approach to a risk assessment approach.¹⁴

The particular feature of this strategy relating to the profession is the recognition that the profession and the ATO are in a relationship of mutual dependence. If the relationship with the profession is properly nurtured the ATO believes that it has the capacity to significantly increase the efficiency of the administration of the tax system with attendant cost savings. Presumably this might be achieved at a number of levels. Firstly, the profession might take a less aggressive approach to advice resulting in greater tax revenues. Furthermore, certain functions traditionally exercised by the ATO might be effectively delegated or outsourced to the profession – certainly a feature of the self assessment system. From the government's perspective an added bonus of a non-adversarial relationship between the collecting authority and the profession is the

appear to be reminiscent of the approach it adopted back then: p 308. Slater suggests that a co-operative relationship remained up to the 1960s but was damaged by the Whitlam Government whose policies led to many regarding tax as optional resulting in suspicion and distrust on both sides: AH Slater, "Tax in Australian society: an 80 year perspective" (2007) 81 *Australian Law Journal* 681 at 689.

¹¹ Initially trialed by the Cash Economy Taskforce established in 1996: see Michael D'Ascenzo, "Chapter 1 - Tax Administration into the 21st century" in Michael Walpole and Chris Evans (eds) *Tax Administration into the 21st century*, A Prospect Intelligence Report 2001 at 1 – 9. Also see Valerie Braithwaite and John Braithwaite, "Chapter 19 – Managing taxation compliance: the evolution of the Australian Taxation Office compliance model" at 215 – 224.

¹² See, for example the report on the 35th annual meeting of the Study Group Asian Taxation Administration and Research ("SGATAR") held in Singapore in November 2005. This is a forum for revenue authorities in the region to discuss ways to improve the administration of revenue collection. It currently has 13 members. The forum identified tax professionals as key influencers of compliance behaviour and that there was a need to shift from the traditional view of antagonism to the tax administrator seeing itself in partnership with taxpayers and their advisers: Gil Levy, "The importance of the relationship between the tax collector and the tax agent" (2006) 40 *Taxation in Australia* 473. Also see the United Kingdom's "working together" program, discussed in Australian National Audit Office, *The Auditor-General Audit Report No 19 2002-03 Performance Audit: The Australian Taxation Office's management of its relationship with tax practitioners* at 55.

¹³ Recently reiterated by the Commissioner: Michael D'Ascenzo, "A new relationship with the tax profession", *Taxation Institute of Australia – 21st National Convention*, 6 April 2006 and also see "Living our values" 7th *International Tax Administration Conference*, Sydney, Australia, 20 April 2006. Also see "Relationships between tax administrators and tax agents / taxpayers", a presentation by Michael D'Ascenzo to the *Asia-Oceania Consultants Association general meeting*, Manila 11 November 2005 and Michael Carmody, "Revitalising the tax administration system: The Australian experience" *Tax Administration Advisory Board Meeting*, Phoenix, Arizona, USA, 11 – 12 January 2005.

¹⁴ See Braithwaite 2005, chapter 5. For a discussion of the pressures motivating the change see Jenny Job and David Honaker, "Chapter 6 - Short-term experience with responsive regulation in the Australian Taxation Office" in Valerie Braithwaite (ed) *Taxing Democracy: Understanding tax avoidance and evasion*, Ashgate 2003 at 111.

favourable message that it sends to multinational companies and other potential foreign investors.¹⁵

III THE PARTNERSHIP IN PRACTICE

The relationship between the tax profession and the ATO had reached an all-time low by 2002. The profession had been under enormous stress following a considerable period of tax reform. It had taken the view that inadequate assistance had been provided during a period in which many extra obligations had been imposed on it and, in particular, there was inadequate recognition of the pressures on the profession in the ATO's approach to compliance deadlines and penalties. This had followed a period where the ATO had adopted an aggressive, albeit belated, approach to certain mass marketed tax schemes. There had been a common view that the ATO's failure to respond to these schemes earlier was a tacit approval of them with the result that the ATO's belated audit activity and imposition of tough penalties was unfair. However it took considerable political pressure on the ATO to retreat from its aggressive position. In this environment tensions between the ATO and the profession resulted in threats by the profession to strike. This had the effect of bringing the ATO to the table to negotiate a renewed relationship.¹⁶

From this low point the ATO has embarked on an enhanced strategy of the provision of assistance and engagement with the profession on matters of significance.¹⁷ In addition to various procedural changes and improved services and information dissemination at the operational level¹⁸ the ATO committed to an improved consultative platform including a specific ATO Tax Practitioner forum. So, for example, a campaign to review the use of service trusts by professionals has been the subject of negotiation resulting in the ATO compromising considerably on its initial position.¹⁹ The application of controversial legislation imposing penalties on promoters of tax schemes continues to be the subject of consultation with the profession.²⁰ The introduction of a consolidations regime for corporate groups has also been the subject of considerable consultation resulting in benign positions being adopted by the ATO together with an educational and assistance program.²¹ A collaborative approach has

¹⁵ There is evidence that punitive tax enforcement may encourage multinationals to move offshore: Robert Lee, "Where tax rates fall, multinational follow" *Tax-News.com*, London (22 May 2006) (www.tax-news.com/asp/story/story_print.asp?storyname=23681) last viewed 1 June 2006.

¹⁶ Discussed in Australian National Audit Office, *The Auditor-General Audit Report No 19 2002-03 Performance Audit: The Australian Taxation Office's management of its relationship with tax practitioners* at 85-86.

¹⁷ Id, 19-20 and see the recommendations of the Auditor-General detailed at 30-33 all of which were endorsed by the ATO.

¹⁸ Discussed in Greg Farr, "Benefits gained from listening and responding to tax agents" (2006) 40 *Taxation in Australia* 602. In particular, the establishment of the ATO relationship manager program would appear to have been particularly effective, at least according to the ATO.

¹⁹ See the report by the Inspector General of Taxation, *Review of the Tax Office's management of complex issues – case study on service entity arrangements*, 24 April 2007 available at <http://www.igt.gov.au/content/reports.asp?NavID=9>. As to the ATO's initial position also see Fiona Buffini and Allesandra Fabro, "ATO widens net on use of service trusts" (18 May 2004) *The Australian Financial Review* at 3. For the ATO's ultimate position see TR2006/2.

²⁰ Discussed in John de Wijn, "Promoter penalties – getting the balance right" (2006) 40 *Taxation in Australia* 395. Also a National Tax Liaison Group Promoter Penalty Co-design Sub-committee has been established by the ATO.

²¹ See Neil Olesen, "Income tax consolidation – legislation now complete" (2003) 37 *Taxation in Australia* 462.

been adopted in developing guidelines on large company audits.²² This would all appear to be coupled with a more conciliatory approach to taxpayers generally.²³

More recently the ATO has included in its statement of its compliance program for 2006/07 a new section focusing entirely on how it sees its relationship with tax practitioners. Essentially the chapter is laden with commitments to continue to consult, co-design and co-operate in all dealings impacting on tax practitioners.²⁴ It has indicated that recent surveys have suggested that these commitments are being honored and that both tax agents and taxpayers feel that they were being treated fairly and with trust and respect.²⁵

A reciprocal approach by tax practitioners has been acknowledged by the President of the Tax Institute who commented in the Institute's journal of August 2006 that it was critical "to foster an open and mature relationship with all levels of the ATO to ensure the best possible outcomes from our consultations". At the same time, however, he warns that the Institute must be vigilant to guard against mere rhetoric from the ATO.²⁶

IV A PARTNERSHIP OF FOES: LIMITS OF THE PARTNERSHIP MODEL

Notwithstanding these developments pointing towards an increasingly collaborative relationship between the profession and the ATO the partnership model is not without its limitations and concerns.

A What common interest?

The essence of a partnership is a fiduciary relationship between the partners under which they undertake to pursue a common interest.²⁷ Whether it is correct to describe the relationship between the ATO and the profession as one in the pursuit of a common interest must be questioned. It could be suggested that, in fact, the two parties have quite opposing goals and interests. At the very general level the ATO is seeking to maximize government revenue whilst the profession is seeking to minimize it. To expect parties from such opposing perspectives to form a partnership is arguably naive. The only common interest they have is to achieve their individual (opposing) aims in the most expeditious manner.

In fact, elements within the ATO may indeed recognize this incongruence because, whilst the bulk of commentary on this topic issuing from the organization is couched in terms of forming community "partnerships", at least one publication retreats from the use of the partnership description to describing the relationship as one of mutual

²² *Large business and tax compliance*, ATO August 2006 available at www.ato.gov.au/large/content.asp?doc=/content/77914.htm.

²³ See footnote 67 following for examples of other concessional positions taken by the ATO.

²⁴ *ATO Compliance Program 2006/07*, ATO August 2006 at 72 – 78 available at <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/77362.htm>.

²⁵ The Commissioner summarises the findings of these surveys at www.ato.gov.au/print.asp?doc=/content/77123.htm.

²⁶ Andrew Mills, "Tax transparency – consulting with the ATO" (2006) *Taxation in Australia* 65.

²⁷ The various State Partnership Acts define a partnership as persons acting in common with a view to profit. Such an arrangement is traditionally distinguished from a joint venture where the parties work together to further their private interests. A joint venture typically imposes less in the way of fiduciary obligations on the parties. Maybe this would be a more apt descriptor of any relationship that might be achievable between the profession and the ATO.

interdependence whereby an interest in the efficiency of tax administration is shared.²⁸ More particularly this shared interest might be described as the desire to ensure that the “correct” amount of tax is paid. This would require the profession to bring to the ATO's attention what it considers to be overly aggressive tax planning. The current Commissioner of Taxation has, in fact, appealed to the profession to adopt this approach.²⁹ However, it begs the question as to what is the “correct” amount of tax and what is overly aggressive tax planning. It could be expected that the ATO would take issue with any deviation from its view of the law whilst the profession may well take an alternative interpretation. How two parties could be viewed as having a shared interest in the application of the tax laws when they do not have a shared view as to what these laws are is problematic.

If it can be said that there is a shared interest then the corollary is that the ATO should identify to the profession tax planning opportunities where taxpayers can legitimately reduce their tax liability. Whilst it might be that some concessionary rulings, such as that dealing with salary sacrifice,³⁰ actually reflect such an approach it could be suggested that the ATO should be going further and audit taxpayers not just from the perspective of identifying tax shortfalls but also from the perspective of identifying missed opportunities to reduce taxation.³¹

B Problems raised by conflicting interests

If it is accepted that there is some common or shared interest between the profession and the ATO then it could be anticipated that the pursuit of this common interest will create conflicts for both the profession and the ATO in relation to their private interests. Which interests should prevail where the profession identifies a planning opportunity for its clients from a clear drafting error which is inconsistent with the proper administration of the tax system? What if a member of the profession identifies an error by the ATO in its client's favour? Is the profession expected to swear allegiance to the administration of the tax system just as lawyers swear allegiance to the courts?³² Similarly is the ATO duty-bound under the partnership model to lobby Government in relation to problems of fairness and inequity that it has unearthed³³ and even to advise

²⁸ ATO, *Strategic framework for the Tax Office's relationship with tax agents*, March 2005 at 3. Also see “Relationships between tax administrators and tax agents / taxpayers”, a presentation by Michael D'Ascenzo to the *Asia-Oceania Consultants Association general meeting*, Manilla 11 November 2005.

²⁹ See “It is the community's tax system”, address to the *Australasian Tax Teachers' Association 18th annual conference*, Melbourne, Australia, 30 January 2006. Since this paper was given the ATO has proposed a dob-in line for tax agents: referred to in a speech by the Commissioner to the *Taxpayers Australia and Superannuation Australia Annual Conference*, Sydney, 10 November 2006. However this has met with resistance from the profession: Elizabeth Kazi, “Tax dob-in line on hold” (27 November 2006) *Australian Financial Review* 1.

³⁰ TR 2001/10.

³¹ One area were the profession is concerned that clients are missing benefits that they would otherwise be eligible to receive because agents are overwhelmed by the complexity of the legislation is consolidations: see the ATO's consultative forum, *Small to medium enterprises sub-committee minutes* for 25 November 2005.

³² The basic rule in most countries is that the tax professional must act in complete independence from the tax administration: Victor Thuronyi, *Tax law design and drafting*, IMF 1998 at 140.

³³ As some have suggested: Pauline Niemirowski, Steve Baldwin and Alex Wearing, “Chapter 18 - Thirty years of tax compliance research: of what value is it to the ATO?” in Michael Walpole and Chris Evans (eds) *Tax Administration into the 21st century*, A Prospect Intelligence Report 2001 at 199 - 213. This obligation appears to be recognized by the current Commissioner who recently stated that not only should the ATO co-design with business sensible administrative approaches that facilitate practical

practitioners of missed deductions or even planning opportunities or is it compelled to maximize tax revenue for the government?³⁴ And if there is alleged to be a breach of duty by either partner is this actionable and, if so, in what venue and what sanctions might be appropriate?

The notion that tax professionals may owe a duty or obligation to the tax system is very controversial.³⁵ Some commentators suggest that the practitioner's role as an enforcer reflects their duty to act in society's best interests³⁶ or that in seeking to earn profits and minimize costs professionals must be held accountable to some level of collective well being³⁷ or that the exercise of professional judgment requires that advice be couched in the context of justice and good faith and lawyers, at least, are responsible to the community³⁸ and to achieving a just termination of disputes.³⁹ How this is reconciled with their role as an exploiter has led others to suggest that they act as

compliance and reduce compliance costs but also it should bring to the attention of Government matters where the tax laws are not operating according to the policy intent or which produce unintended consequences or unexpected and significant compliance costs: Michael D'Ascenzo, Address to the *PricewaterhouseCoopers Boardroom Dinner*, Brisbane, 28 June 2006.

³⁴ The need for the ATO to balance divergent interests between itself and the profession was recognized in Australian National Audit Office, *The Auditor-General Audit Report No 19 2002-03 Performance Audit: The Australian Taxation Office's management of its relationship with tax practitioners* at 46.

³⁵ Whilst the accounting and legal profession are subject to professional standards these are typically open-ended and subject to interpretation in practice. For example, see paragraph 20 of the *Statement of Taxation Standards (APS 6)* issued by the Institute of Chartered Accountants of Australia requiring members who become aware of a client's non-disclosure to "carefully consider whether [they] should continue acting for that client," although note paragraphs 25 and 26 which specifically mandate that Institute members should not associate themselves with tax schemes. (APS 6 available at http://nxt.pearsoned.com.au/NXT/gateway.dll/?f=templates&fn=default.htm&vid=ICAA:MembersHandbook.Guest.Enu&NPAC_CREDENTIALSPRESENT=TRUE.) Note that effective from 1 July 2008 APS 6 is to be replaced by APES 220, paragraph 7.6 of which also mandates that a client's failure to disclose should cause the member to reconsider their engagement. Similarly paragraph 5.4 provides that members should not promote or encourage tax schemes. Potentially of significance is paragraph 3.2 that provides that members shall observe and comply with their public interest obligations when they provide taxation services: Accounting Professional and Ethical Standards Board Ltd, *APES 220 Taxation Services*, October 2007 available at <http://www.apesb.org.au/>.

³⁶ See Rebecca L Attwell and Adrian J Sawyer "The ethical attitudes of New Zealand tax practitioners - still "barely passing"?" (2001) 7(2) *New Zealand Journal of Taxation Law and Policy* 111 at 113, also citing PMJ Reckers, DL Sanders and RW Wyndelts, "An empirical investigation of factors influencing tax practitioner compliance" (1991) 13 *The Journal of the American Taxation Association* 30 at 32. See also LS Shapiro, "Doing what is right" (1996) 41(12) *National Public Accountant* 7.

³⁷ Don R Hansen, Rick L Crosser and Doug Laufer, "Moral ethics v Tax ethics: the case of transfer pricing among multinational corporations" (1992) 11(9) *Journal of Business Ethics* 679, disagreeing with Urmson quoted as suggesting that the duty of the tax practitioner is to assist the client in complying with the law and going beyond this requirement should be left to saints: Urmson, "Saints and heroes" in Meldon (ed), *Essays in Moral Philosophy* 1958. For another appeal to tax practitioners to demonstrate a concern for moral considerations beyond that required by law or economic efficiency see Alan Stainer, Loric Stainer and Alexandra Segal, "The ethics of tax planning" (1997) 6 *Business Ethics* 213.

³⁸ Tony Greenwood, "Ethics and avoidance advice", presentation to the *Australian Institute of Directors seminar The New Corporate Morality*, Melbourne, 21 March 1991.

³⁹ Alvin B Rubin, "A causerie on lawyers' ethics in negotiation" (1975) 35 *LA Law Review* 577. Thus it is argued that a lawyer should not accept a result that is unconscionably unfair to the other party because, perhaps, the other party had acted on mistaken facts. This duty to the profession and society must supersede any duty to the client. On this basis full disclosures should be made to the Tax Authority (even of material it may not have requested) and it should be advised of deficiencies in the taxpayer's case.

exploiters where the tax laws are ambiguous and enforcers where the tax laws are clear and unequivocal.⁴⁰

Others decry any duty to the system. The Taxation Institute of Australia's then President stated in 1994 that the sole responsibility of the tax professional is to their client and if anyone has a duty to the community in regard to tax it is the taxpayer. Any duty the professional has is performed by discharging their responsibilities to their clients.⁴¹ Surveys of both New Zealand⁴² and Western Australian tax practitioners⁴³ have confirmed that few acknowledge a duty to the taxing authority or, indeed, to act in the public interest.

If it is indeed the case that tax advisers have no obligation to the system then it does not bode well for partnership relations. It also raises doubts as to the motives of tax advisers who purport to embrace the partnership model. If they have no regard for the interests of the system they might just be employing a subterfuge to surreptitiously promote the interests of their clients?

But, of course, the absence of some acknowledged duty to the system does not prevent practitioners adopting an ethical attitude that sees them balance the interests of their clients and society. If, indeed, tax advisers do exhibit high tax ethics then this would encourage the view that they might embrace the partnership model in the appropriate spirit. Unfortunately surveys to date seeking to assess the ethical attitudes of tax advisers suggest that they are "barely passing"⁴⁴ and there is considerable diversity among Australian tax practitioners in the ethical stances they take.⁴⁵

This debate as to tax adviser loyalties goes to the heart of what we see as the role of tax advisers. During the late 1980s this became a contentious issue in the United States with the publication of the results of an Internal Revenue Service ("IRS") sponsored survey of tax advisers from which a negative impression was drawn by the IRS as to their impact on tax compliance. In their review of this development Jackson and Milliron suggested that the practitioner's role lies somewhere along a spectrum with government agent at one end and taxpayer advocate at the other. However there was disagreement between the IRS and practitioners as to where on the spectrum their role should lie. Whilst the practitioners acknowledged that they had a dual responsibility to the system and to clients the later was their primary responsibility whereas the IRS was attempting to force practitioners towards the agent end of the spectrum.⁴⁶ Jackson and

⁴⁰ Maryann Richardson and Adrian Sawyer, "A taxonomy of the tax compliance literature: further findings, problems and prospects" (2001) 16 *Australian Tax Forum* 137 at 208 – 212 referring to the work of S Klepper, M Mazur and D Nagin, "Expert intermediaries and legal compliance: the case of tax preparers" (1991) 34 *Journal of Law and Economics* 205.

⁴¹ David Russell QC, "The client's interests always take priority" (1994) 28(8) *Taxation in Australia* 431. Also see AJ Myers, "Tax advice: the lawyers ethical responsibility" (1990) 19 *Australian Tax Review* 80 – 87.

⁴² Attwell and Sawyer, at 128 – 129 reporting a similar finding to ST Tooley, "Tax practitioners: towards an understanding of ethical problems and attitudes in taxation", Paper presented at the 1992 AAANZ Annual Conference, Palmeston North, New Zealand.

⁴³ RL Marshall, RW Armstrong and M Smith "The ethical environment of tax practitioners: Western Australian evidence" (1998) 17 *Journal of Business Ethics* 1265 at 1273.

⁴⁴ See Tooley, supra and Attwell and Sawyer, supra at footnote 28 citing Y Song and TE Yarborough, "Tax ethics and taxpayer attitudes: a survey" (1978) 38 *Public Administration Review* 442. Compare RL Marshall, RW Armstrong and M Smith "The ethical environment of tax practitioners: western Australian evidence" (1998) 17 *Journal of Business Ethics* 1265 – 1279.

⁴⁵ Yuka Sakurai and Valerie Braithwaite, "Taxpayers' perceptions of practitioners: Finding one who is effective and does the right thing?" (2003) 46 *Journal of Business Ethics* 375 – 387.

⁴⁶ The then Director of Practice at the IRS, Leslie S Shapiro, wrote of the practitioners' responsibility to the tax system being paramount. Practitioners were expected to be fair and honest in their dealings with

Milliron suggested that there was a potential danger for the government's interests in this redefinition in the role of tax advisers to the extent that it drove taxpayers away from tax practitioners. The effectiveness of the subtle outsourcing to the profession of the IRS's compliance mandate would be jeopardized.⁴⁷

As is discussed below, the issue of the duties that tax advisers' owe and their exact role may, in turn, depend on the type of adviser and their exact retainer. That is, it may not be possible to generalise across the spectrum of different types of advisers due to their eclectic nature.

If tax practitioners do owe some duty to the system or are properly to be seen as agents of the taxing authority then how is this to be reconciled with their legal obligations to their clients. Together with the more esoteric duty of loyalty an adviser owes their client a duty of confidentiality.⁴⁸ Conceivably disclosure of a client's circumstances to the ATO without their permission might expose the adviser to either common law or contractual liability or breach of professional rules. It is unclear as to whether and, in what circumstances, the fact that the client was in breach of the taxation laws would be a defence to such a claim.⁴⁹

Irrespective of whether an adviser has an obligation or discretion to disclose a breach of the law, an adviser must always be cautious of not exposing themselves to liability under the taxation or criminal laws from their client relationships. Whilst a legal obligation or entitlement to disclose a breach of the law might provide a defence to any action by the client it would appear that the scope of the aiding and abetting provisions would not seem to encompass a simple failure to disclose as the focus is on the "commission" of a positive act.⁵⁰ However there has been debate in recent years as to the possible extension of the good Samaritan laws to require citizens to disclose the commission of offences of which they are aware.⁵¹

With the advent of the ATO's partnership model the nature of the tax adviser's role assumes particular significance. The Commissioner in a recent controversial presentation spoke of his vision which allowed high levels of professional standards to be blended with social and ethical responsibilities. He suggested that tax professionals should give something back to the country in terms of balanced and constructive input on the shape of the tax system, intelligence on how it was operating on the ground⁵² and feedback on the quality of tax administration. They should be open about defects in the tax laws whether they exposed loopholes that disadvantaged the revenue or unintended consequences that disadvantaged taxpayers. The Commissioner conceded that the changes in thinking within the ATO were difficult and would take time but also called

the IRS and foster confidence in their clients in the integrity of the tax system and in complying with it: "Professional responsibility in the eyes of the IRS" (March 1986) *The Tax Adviser* 136 at 139.

⁴⁷ Betty R Jackson and Valerie C Milliron, "Tax preparers: government agents or client advocates?" (1989) 167(5) *Journal of Accountancy* 76 - 83.

⁴⁸ See Gino E Dal Pont, *Lawyers' Professional Responsibility*, Lawbook Co 2006 at 75 - 78 and chapter 10.

⁴⁹ Id, chapter 10, especially at 231 and 234. Whilst disclosure of confidential information might be compelled by statute this is less likely where the confidential information is also subject to legal professional privilege in the absence of express provision: at 232.

⁵⁰ Id, 425 - 427.

⁵¹ Andrew Ashworth, "The scope of criminal liability for omissions" (1989) 105 *LQR* 424.

⁵² The ATO has recently proposed a tax practitioner integrity line to enable tax agents to raise issues of concern about what they are seen in the marketplace: see Michael D'Ascenzo's speech to the *Taxpayers Australia and Superannuation Australia Annual Conference*, Sydney, 10 November 2006.

upon the profession to reconsider its role in the care and management of the tax system.⁵³

C The eclectic nature of tax advisers

As noted above this issue is compounded by the fact that the partnership model also fails to appreciate that the tax advising profession is an eclectic group ranging from tax agents and suburban accountants to international tax advisers and tax barristers.⁵⁴ Both the role they play and the approach of these individuals in dealing with the ATO differ significantly across the spectrum. It is universally acknowledged that accountants in a tax planning role typically approach a client's tax obligations with the view to processing them through the system as painlessly as possible whilst legal advisers tend to be more aggressive in the approach they mandate to dealing with the tax authority.⁵⁵ Furthermore, recent experiences in the United States and Australia with tax schemes would suggest that the schemes are supply driven, at least initially, reflecting that there is a very aggressive cohort of advisers who could not be said to share any common interest with the tax authority.⁵⁶

The United States manual on tax practice standards⁵⁷ acknowledges the distinction between an advocate, whose paramount duty is to zealously represent the client, and an adviser, whose pursuit of their client's interests may be constrained by a duty to see that the tax system is not improperly used by the taxpayer. Whilst acknowledging that there is a view that a practitioner's loyalty is solely to their client, the authors suggest that the better view is that the practitioner owes a duty to the system to encourage compliance with the law.⁵⁸ The key to the relative weightings of the dual responsibilities depends on the extent to which the practitioner is engaged in adversarial proceedings, although it is acknowledged that this is not always easy to delineate.⁵⁹ In particular, in disputes or, possibly, on an audit there is no duty to disclose adverse precedent or reveal unfavourable facts to the taxing authority.⁶⁰ On the other hand, a tax planner's duty to the system may override the duty to the client, especially when filing a rulings request.⁶¹ When acting as a negotiator, whilst the practitioner is probably acting as an advocate, the authors counsel against whether an adversarial strategy will necessarily

⁵³ Michael D'Ascenzo, "Cultural shifts in thinking - what if?" address to the *Allens Arthur Robinson dinner*, 7 September 2006. The editor of the Australian Financial Review probably summed up the response of many practitioners to this presentation by suggesting that the Commissioner was "having himself, and us on" as this would simply create a climate of distrust: ATO needs better laws, not informers", (9 October 2006) *Australian Financial Review* at 70. Also see Elizabeth Kazi, "ATO seeks informants" (6 October 2006) *Australian Financial Review* at 13.

⁵⁴ See Australian National Audit Office, *The Auditor-General Audit Report No 19 2002-03 Performance Audit: The Australian Taxation Office's management of its relationship with tax practitioners* at 41-44.

⁵⁵ See Victor Thuronyi, *Tax law design and drafting*, IMF 1998 at 148. Also see Roman Tomasic and Brendan Pentony, "Tax compliance and the rule of law: from legalism to administrative procedure?" (1991) 8 *Australian Tax Forum* 85.

⁵⁶ Braithwaite 2005. Also see Prem Sikka and Mark P Hampton, "The role of accountancy firms in tax avoidance: some evidence and issues" (2005) 29 *Accounting Forum* 325.

⁵⁷ Bernard Wolfman, James P Holder and Kenneth L Harris, *Standards of Tax Practice*, Tax Analysts, 5th edition, 1999.

⁵⁸ *Id.*, 4 and 52.

⁵⁹ *Id.*, 49 – 52. The stance that the adviser should adopt may depend on the nature of the penalty at issue – is it designed to discourage certain conduct or merely impose an economic cost?

⁶⁰ *Id.*, 361, 364 and 366. But it might be advisable from a reputational perspective to advise the IRS of conflicting precedent.

⁶¹ *Id.*, 374 – 375 and 413.

best serve a client's interests and rather suggest that a co-operative strategy may be preferable. Regardless of the strategy adopted it is suggested that the appropriate goal is to seek to achieve the optimal result for the client. Thus concealment, puffery and other persuasive techniques would appear acceptable provided truthfulness is maintained.⁶² In contrast the tax authority and its advisers may have greater constraints on their pursuit of the Government's interests on the basis that they have a greater obligation to achieve a just outcome, although the authors acknowledge that this is open to debate.⁶³

The distinction between roles and their respective obligations has been justified by other commentators on the basis that a tax system based on self assessment is by its nature a co-operative effort between taxpayers and the government and the effectiveness of the system is threatened by advisers who treat the return preparation and examination process as adversarial. Rather there is a duty to society on both advisers and taxpayers at the preparation and examination stage that requires full disclosure, including of opposing arguments and material not requested by the Taxing Authority, so that a considered debate can occur. It is inappropriate for taxpayers to "win" by default as can occur under an adversarial system. Only once a taxpayer has satisfied the disclosure requirements should advisers be free to advocate on behalf of taxpayer positions. These commentators suggest that tax advisers must respect their dual responsibilities and be prepared to put the good of the system ahead of that of client loyalty when clients refuse to disclose.⁶⁴

Notably these commentators accept that an adversarial approach may nevertheless be called for at the dispute resolution level as distinct from the return preparation and examination level. Could it be that the partnership model should be limited to pre-litigation/dispute processes?

However there is an emerging field of law known as "collaborative practice" which suggests that a shared problem resolving approach can be an appropriate model to resolve disputes. This model had its genesis in the practice of family law in the early 1990s but is now presenting as an alternative dispute resolution mechanism in other areas of practice. It is premised on the parties entering into written commitments to deal with each other in a collaborative way, making full disclosure and then each party and their advocates attempting to understand and accommodate the goals and interests of the other. In a sense the clients and their advocates work together as members of a partnership rather than against each other as opposing parties. This is a particularly useful model to sustain a positive relationship in cases where a continuing relationship between the parties is either designed or necessary.⁶⁵ Its potential relevance to tax litigation is accordingly apparent although yet to be embraced. If the partnership model is to be properly viewed as applicable to the resolution of tax disputes as well as tax return preparation and administration generally then the collaborative practice procedure would appear to supply the appropriate methodology. However this would require commitment from both parties and a significant cultural shift.

⁶² Id, 415 – 418. Contrast Alvin B Rubin, "A causerie on lawyers' ethics in negotiation" (1975) 35 *LA Law Review* 577.

⁶³ Id, 497 – 498.

⁶⁴ Loren D Prescott Jr, "Challenging the adversarial approach to taxpayer representation" (1997) 30 *Loyola of Los Angeles Law Review* 693. Also see Alvin B Rubin, "A causerie on lawyers' ethics in negotiation" (1975) 35 *LA Law Review* 577.

⁶⁵ Discussed in Karen J Levitt, "The emerging field of collaborative practice" (2006) 4 *Collaborative Law Journal* 14 and see the International Academy of collaborative professionals at www.collaborativepractice.com.

The eclectic nature of the profession also makes it difficult for that ATO to identify professional associations that are truly representative of the profession with whom it can consult and engage. For example, the interests of suburban accountants and tax agents may not always be best represented by the Tax Institute and the Institute of Chartered Accountants as these bodies tend to be heavily influenced by individuals advising the big end of town. Furthermore, there is never a guarantee that these bodies are fully across the issues at the coalface of tax practice and may themselves be in some form of denial of the difficulties faced by practitioners as the existence of these problems may be perceived as an indictment of their own performance and relevance.

D The absence of transparency, the question of legitimacy and the loss of independence for the ATO

Notwithstanding the rhetoric from the ATO hierarchy endorsing the partnership approach, the evidence is that the ATO has demonstrated inconsistency in its approach to the partnership model. It seems that sometimes it embraces a consultative and conciliatory approach whilst on other occasions it adopts an aggressive adversarial approach. Whilst this contrast in approaches may to some extent be reflective of its perception of the attitude of the relevant taxpayers towards compliance and, hence, reflect the enforcement pyramid at work this would not seem to justify all examples of inconsistency.⁶⁶ As a result some taxpayers harbour a perception that the big end of town and high net worth individuals with their high level connections may be able to achieve more favourable outcomes from their “partnership” with the ATO than other taxpayers, such as employees and small businesses.⁶⁷

⁶⁶ For example, the ATO’s test case program was recently the subject of criticism by the Inspector General of Taxation for inappropriately being dominated by compliance objectives, lacking integrity and not respecting court decisions: see Elizabeth Kazi, “ATO forced to overhaul court tactics” *The Australian Financial Review* (8 August 2006) 1 and 6. Also the ATO’s position on the exercise of its information gathering powers has been attacked as coercive irrespective of the co-operation shown by the taxpayer and therefore hardly consistent with mutual trust and co-operation: Fleur Anderson, “ATO retains right to raid” *The Australian Financial Review* (1 September 2006) 8. For further evidence of non-partnership like conduct see the references at footnote 82 following.

⁶⁷ Elizabeth Colman, “Tax office accused of granting favours to the big end of town” *The Australian* (3 March 2006) 21. This perception may be ill founded as recent concessionary positions taken by the ATO do not appear to be restricted to large business issues. For example, see the outstanding debts concession for small businesses instigated in June 2004 (discussed in Michael D’Ascenzo, presentation to the *Council of Small Business Organisations of Australia*, Melbourne, 27 June 2006), PS LA 2006/2 (statute barred private company loans made prior to the enactment of Div 7A of the *Income Tax Assessment Act 1936* (“ITAA36”) are not deemed dividends), PS LA 2006/1 (the cost base for capital gains tax is not required to be reduced where Div 43 of the *Income Tax Assessment Act 1997* (“ITAA97”) deductions are not taken because the information to determine construction costs are not available), PS LA 2005/24 (Part IVA of the ITAA36 not to apply to typical husband and wife partnerships) (referred to in Fleur Anderson, “ATO gives ground on tax schemes” (14 December 2005) *The Australian Financial Review* 1), ATO media release Nat 2004,58, 4 August 2004 (superannuation recontribution strategies are not caught by Part IVA), ATO case analysis on *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* at <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/77529.htm> (the decision, holding that whether the sale of real property was of input taxed residential premises depended on the subjective intention of the purchaser, is not to be followed due to the difficulties it generates for vendors) and TR 2006/2 (accepting the deductibility of services fees paid to services trusts). Whilst the later ruling is primarily relevant to the big end of town (or at least to their advisers) it presents an interesting example as the concessions contained therein have been the subject of criticism by some sectors of the media

Whether this perception is correct or not it illustrates the transparency issues that arise from the partnership model. Whenever the ATO compromises or settles a tax dispute the issue arises as to why the ATO may have adopted a particular conciliatory approach on this particular issue whilst maybe adopting a more aggressive approach on another. Such conduct often creates a perception of bias for those taxpayers who have not been the beneficiary of the concession. Given that perceptions of fairness have been found to be significant in ensuring taxpayer compliant behaviour⁶⁸ it is incumbent on the ATO to clearly enunciate the basis for any concessions it bestows. Whilst this issue is not peculiar to the partnership model it is much more likely to arise and presents a significant potential flaw in the model.⁶⁹

In addition to the implications of decisions that prefer one taxpayer over another, the granting of administrative concessions also raises the issue of the powers of a tax authority to negotiate away tax revenue.⁷⁰ In Ireland, for example, the co-operative compliance approach, as it might be described there, has been attacked by the profession on the basis that the Internal Revenue Service (“IRS”) should apply the rule of law and has only limited discretion. Purported exercises of discretion are not only potentially ultra vires but can lead to bias, a perception of unfairness and discriminate against the compliant. Businesses that are not aggressive might thereby lose market share. Irish practitioners would seem to prefer their tax authority to be universally aggressive in its approach to applying the law.⁷¹ Otherwise the proposed bargain seems like “a bargain where one side is promising nothing and the other side is promising what they cannot deliver”.⁷² All these comments are equally applicable to the ATO. The organization needs to be conscious of the limits of its authority in making decisions that have a tax policy element, particularly where the decision discriminates in favour of or against sections of the community.

To the extent that a collaborative approach by the ATO is, arguably, more likely to lead to tax amnesties and similar concessions the ATO needs to be cognizant of the literature on the implementation of tax amnesties that suggests that such amnesties tend to have negative revenue effects because of the negative signaling effect or due to the reduced fear of the consequences of further evasion / avoidance.⁷³ Whilst there is some evidence that amnesties and concessions can be effectively instituted⁷⁴ this literature

whereas the professional organizations continue to complain that the concessions achieved still do not go far enough and the ruling is harsh.

⁶⁸ For example, see Grant Richardson, “A preliminary study of the impact of tax fairness perception dimensions on tax compliance behaviour in Australia” (2005) 20 *Australian Tax Forum* 407.

⁶⁹ On October 12, 2007 the Inspector General of Taxation announced a review into the ATO's settlement activities in particular focusing on the effectiveness of governance processes and assurance measures in engendering confidence in ATO settlements, the alignment of these settlements with the compliance model and the effectiveness that transparency measures in relation to settlements have in addressing perceptions of potential favouritism: see further at www.igt.gov.au.

⁷⁰ As to the limits of the Commissioner's powers to negotiate and compromise see Ray Conwell, “The Commissioner's Discretion's and Indiscretions - Changing attitudes to the use of the Commissioner's Powers”, *Taxation Institute of Australia 9th National Convention*, Adelaide 1990.

⁷¹ PJ Henehan and Aidan Walsh, “Beware of tax officials bearing gifts in large cases” (2004) 17(2) *Irish Tax Review* 133 (“Henehan and Walsh”). Some Australian advisers would also seem to prefer a more robust approach: Braithwaite 2005 at 64.

⁷² Henehan and Walsh, 140. It should be added, however, that the Irish model is solely focused on the relationship between the IRS and taxpayers and seeks to sideline the tax profession.

⁷³ Adrian Sawyer, “Targeting amnesties at ingrained evasion – a New Zealand initiative warranting wider consideration?” *Australasian Tax Teachers Conference*, Wellington, New Zealand, January 2005.

⁷⁴ Id, 3 – 15. Also see DJ Hasseldine, “Tax amnesties: an international review” (1998) 52 (7) *Bulletin for international Fiscal Documentation* 303.

illustrates that the partnership model may need to be adopted by the ATO with caution or even selectively if a compliance dividend is to be achieved.

Associated with the transparency issue is the risk to the ATO of exploitation of the model by the profession and / or interference in its implementation by the Government at the behest of lobby groups. The ATO needs to establish very clear parameters on which it is prepared to negotiate and compromise. Given that tax issues typically have a very public face the profession can be expected to use all means at its disposal to influence the outcome, means unavailable to the ATO. This may include publicity supporting its position as well as lobbying politicians and other functionaries, for example the Tax Ombudsman and Inspector-General, with the aim of putting pressure on the ATO.⁷⁵ Further there is also no guarantee that the profession will see a negotiated position as an end but rather maybe as a beginning. That is, poorly qualified concessions by the ATO might be adopted by the profession as the basis for further tax minimization opportunities. Also they might be used as precedents in further negotiations.⁷⁶

Certainly there are dangers from the model for the independence of the tax authority.⁷⁷ The potential for conflicts of interest is not restricted to the profession. Grbich argues that the conflicts of interest for the ATO are such that it can be readily manipulated into pandering to the concerns of big business and its advisers. The risk is that it adopts a too compliant attitude to the views of taxpayers, its so-called “clients”,⁷⁸ and puts too little emphasis on protecting the revenue base. Ultimately institutionalized tax avoidance might be sanctioned⁷⁹ and the “regulatory capture” is exploited by business advisers fully aware of the tactical advantage that the collaborative approach hands them. The partnership model, in Grbich’s words, can have the result that:

The raping, plundering barbarians, the very taxpayers who competed so hard for the Olympic gold as Australia’s most recalcitrant tax compliers, have been given the combination to the lock of the royal harem and Crown jewel house.⁸⁰

⁷⁵ For example, see the complaints raised with the Inspector-General by corporations as publicized in Alessandra Fabro, “ATO hard line faces scrutiny” *The Australian Financial Review* (14 August 2005) 3. Either the ATO seems to have a patchy co-operative culture or the profession is using all the resources at its disposal to achieve the best results for its clients.

⁷⁶ As an example of intervention by the Inspector-General and pressure placed on the ATO to extend settlement concessions to a wider group of taxpayers see Katharine Murphy and Elizabeth Colman, “Taxman told to offer better deal in dispute” *The Australian* (1 March 2006) 31.

⁷⁷ Yuri Grbich, “After Bellinz and Ralph: a new focus for decision-making in the Australian tax system” in Michael Walpole and Chris Evans (eds), *Tax administration into the 21st century*, Prospect Media 2001 at 11.

⁷⁸ In New Zealand the terminology that has been adopted is “customers”. Prebble would apparently share Grbich’s concerns as he attacks the change in terminology and the use of “fairness” mottoes by the Internal Revenue Department as creating unreal expectations and internal uncertainty as to the role of the taxing authority. Such language smacks of a too greater desire to be flexible in applying the law in an attempt to appease taxpayers: John Prebble, “Chapter 7 - Customers, branding, mottoes and the New Zealand Inland Revenue Department” in Michael Walpole and Chris Evans (eds) *Tax Administration into the 21st century*, A Prospect Intelligence Report 2001 at 83 – 88.

⁷⁹ Mark Burton, “Taxation of intergenerational wealth transfer – the next tax compliance runaway train?”, Unpublished Manuscript, University of Canberra 2004.

⁸⁰ Yuri Grbich, “After Bellinz and Ralph: a new focus for decision-making in the Australian tax system” in Michael Walpole and Chris Evans (eds), *Tax administration into the 21st century*, Prospect Media 2001 at 11.

V A PARTNERSHIP IN NAME BUT WHO IS KIDDING WHO: MUTUAL INTEREST OR SELF INTEREST?

Professor Parsons once said in relation to the application of the general anti-avoidance rule that tax avoidance is a game in which you can win as long as it does not appear that you are trying to win.⁸¹ In a similar vein, the limitations of the partnership model raise a suspicion that the so called partners are not sincere in their apparent attempts to forge a partnership. That is, they do not trust each other, nor maybe should they. Could it be that both the ATO and the profession see the rhetoric of partnership as a tactic to be employed in the adversarial combat in which they are engaged?

There is ample evidence that either the ATO is, at worst, not sincere or, at best, the co-operative model is failing to filter down from senior management to the auditors. For example, in 2005 the ATO and the Corporate Tax Association commissioned a report in response to concerns that large corporations remained dissatisfied with their relationship with the ATO notwithstanding the ATO's supposed adoption of the co-operative approach. Senior executives of fifteen of some of the largest companies were interviewed by a non-partisan investigator. His findings were that the companies were of the view that frequently the co-operative approach was not reciprocated by ATO staff. It was thought that some in the ATO saw co-operation as a one-way street which may well have been beneficial to the ATO but that companies were receiving little in the way to assist them with their problems in return. In turn this perceived lack of reciprocity was unlikely to encourage the level of co-operation sought by the ATO.⁸²

Of course the companies in their responses to this enquiry may also have been engaged in a game of brinkmanship attempting to exhort an even more conciliatory approach by the ATO. Nevertheless, and rather surprisingly, the ATO has even admitted that it sees the co-operative approach as a means to gather intelligence.⁸³ Whilst this may seem a reasonable strategy and the Commissioner is to be applauded for his honesty its acknowledgement is hardly likely to assist in gaining the trust of the profession.

The criticisms of the ATO in the Inspector-General of Taxation's 2005-06 report might also suggest that the ATO is either not sincere or has a long way to go. This report suggested that the ATO culture needed to change from a defensive posture to one that accepted and acknowledged errors. Furthermore, it was failing to deliver on its commitment to not prejudging taxpayers and being flexible and transparent in its approach to settlements. Most telling the report suggested that the ATO had even failed

⁸¹ Ross Parsons, "Income Taxation - An Institution In Decay" 3 (1986) *Australian Tax Forum* 233 at 259.

⁸² Kevin Burges, *Report on the concerns of a number of the largest companies in the large business segment, with ATO audit, investigation, and advice procedures*, 30 April 2005 especially at 26 – 28. The ATO has indicated that it is responding to these findings; "The way forward for the Tax Office", speech by Michael D'Ascenzo to the *Pricewaterhouse Coopers CFO quarterly dialogue breakfast*, Sydney, 10 May 2006. Also see Cynthia Coleman and Margaret McKerchar, "The chicken or the egg?: A historical review of the influence of tax administration on the development of income tax law in Australia" in John Tiley (ed) *Studies in the history of tax law*, Hart Publishing 2004, 285 at 308 - 309 where it is suggested that whilst the ATO denies that the current tax climate is adversarial this view is not shared by tax professionals. Furthermore, practitioners who attend the consultative meetings claim that they are frustrating and rarely lead to achievable outcomes.

⁸³ See Braithwaite 2005, chapter 13 and also comments by the Commissioner Michael D'Ascenzo in "It is the community's tax system", address to the *Australasian Tax Teachers' Association 18th annual conference*, Melbourne, Australia, 30 January 2006.

to deliver in its professed partnership with the Inspector-General himself by employing delaying tactics and otherwise hindering the Inspector-General's reviews.⁸⁴

The sincerity of practitioners towards the partnership model is also questionable. There is some evidence that they simply pay lip service to it as a strategy to further the interests of their clients. This is implicit in the apparent reluctance to acknowledge any duty to the system and the primacy given to clients' interests in surveys of the profession.⁸⁵ It is also implied from the findings of Tomasic and Pentony who conducted 141 interviews with tax practitioners and ATO employees during 1989 – 1990 primarily focused on perceptions of the rulings systems.⁸⁶ Interestingly they found that an informal and co-operative approach existed between the ATO and the profession at the time with aggressive tax schemes a rarity. Apparently a change in style of practice had occurred away from the adversarial approach of the 1970s due to increases in perceived risk levels, namely the less legalistic approach of the judiciary, greater powers of the ATO (especially the availability of the general anti-avoidance provisions of Part IVA) and the increased costs of litigation. It would appear that something shortly happened to change the mindset of practitioners given the prevalence of schemes that sprang to life during the 1990s. Possibly one factor was the ATO's initial hesitance in applying Part IVA. Maybe, as Braithwaite suggests, this is just a cyclical pattern a generation behind the United States.⁸⁷ In any event, as at 1990 Tomasic and Pentony found that practitioners tended to rely on a "smell test", not as to whether an arrangement was in accordance with the law but rather whether it was likely that the ATO would contest it. Thus practitioners were not so much focused on the "spirit of the law" but rather the "spirit of the times". This raises another possible driver of the tax schemes of the 1990s, the very conciliatory and co-operative approach that the ATO was demonstrating at the start of the decade. Maybe practitioners see the increasingly co-operative nature of the ATO as a weakness to be exploited which, in turn, will generate or contribute to a bust and boom cycle.⁸⁸

⁸⁴ *Inspector-General of Taxation Annual Report 2005-06*, Commonwealth of Australia, October 2006 (http://www.igt.gov.au/content/reports/2005_06_annual_report/html/contents.asp) reported in Elizabeth Kazi, "ATO lashed over unfair tactics" (24 October 2006) *Australian Financial Review* 1 and 6 and also see Elizabeth Kazi, "Tax Inspector to watch his words" (3 November 2006) *Australian Financial Review* 3. Also see the Inspector-General's announcement of a review of GST audits. This review follows concerns that the ATO is pursuing matters that result in no net return for the revenue and are trivial, is over-penalising taxpayers, fails to understand industry practice and is employing unfair tactics and taking too long: Inspector General of taxation web site at www.igt.gov.au/content/work_program/20061030.asp. If these concerns are validated this adds credence to the view that a partnership relationship is not materialising in practice. The Inspector General's Review into the ATO's management of tax litigation was also highly critical of the ATO's lack of objectivity and fairness and failure to seek to resolve matters at an early stage: http://www.igt.gov.au/content/reports/Litigation_report/default.asp

⁸⁵ See the references at footnotes 41 – 43 below.

⁸⁶ Roman Tomasic and Brendan Pentony, "Tax compliance and the rule of law: from legalism to administrative procedure?" (1991) 8 *Australian Tax Forum* 85. Again a distinction was apparent between the views of accountants and solicitors. Accountants place more importance on a good non-adversarial relationship with the ATO than solicitors appear to.

⁸⁷ Braithwaite 2005 at 17. Also see pages 37 - 42 for a brief history of aggressive tax planning in Australia.

⁸⁸ Cf Braithwaite 2005 at 177 – 178. He argues that regulatory agencies must not enter into a see-saw between a persuasive approach and a heavy handed approach. Rather a persuasive approach should be coupled with an escalation process to punish the recalcitrant. This is his thesis of "responsive regulation".

VI CAN THE PARTNERSHIP MODEL WORK?

If we assume that responsive regulatory theory is correct and a partnership style relationship between the ATO and the profession will return the greatest compliance dividend and if, irrespective of the doubts raised above, we assume that the parties are sincere in their efforts to implement the partnership model then how can the limitations of the model be best resolved and what features might enhance its chances of success?

The analysis here would suggest that a change in mindset of both practitioners generally and at all levels of the ATO is necessary. Express acknowledgement of conflicting duties and interests together with agreement on expectations is necessary. This applies equally to the ATO as well as to the profession. The establishment of parameters by which to delineate the appropriate response by the ATO and consistency of treatment are critical. If, as the ATO's compliance model would suggest, a more aggressive and adversarial approach is sometimes warranted the circumstances in which this approach will be employed must be clearly articulated and the decisions made transparent. The adversarial approach needs to be quarantined to those identified circumstances if the trust of the profession is to be garnered.

Indeed, the partnership model must be viewed against the background of the principles of good tax administration. Whilst tax administration must be both effective (capable of achieving a high level of compliance) and efficient (capable of minimizing administrative costs per unit of tax revenue) it must also satisfy the criteria of fairness, transparency and accountability.⁸⁹ Unless the partnership model is carefully handled by the ATO there is a risk that effectiveness and efficiency considerations can dominate at the expense of the other criteria.

The partnership model should not be viewed in isolation from other endeavours to improve the administration of the tax system and reduce avoidance. The lowering of tax rates, the broadening the tax base and the removal of anomalies all serve to limit the avoidance opportunities and incentive. Furthermore, if a cultural shift can be managed to change the attitudes of taxpayers and advisers towards a more compliant mentality then in this environment the partnership model is more likely to flourish.

VII CONCLUSION

The hierarchy of the ATO has set Australian tax administration on a new course. A partnership or collaborative relationship with the profession is to replace the traditional adversarial approach. The ATO hopes that, together with responsive regulation and its enforcement pyramid, the partnership with the profession will encourage voluntary compliance and return a compliance dividend for the Government.

The partnership model has been embraced by the ATO hierarchy with zealous enthusiasm. However its successful implementation is not assured. This paper has sought to identify that many issues need to be explored and resolved. Further research on advisers' perceptions of their role and relationship with the ATO would inform the question as to whether the partnership model is, indeed, realistic and what more needs to be done to implement it at the "coalface". In addition, research on strategies that

⁸⁹ Anuphan Kitnitchiva, "Accountability and fairness in tax administrations – a case study of the Thailand revenue department" (March/April 2006) *Asia-Pacific Tax Bulletin* 76.

have been employed in other countries would also be valuable.⁹⁰ The model is very much a work in progress.

⁹⁰ In particular the United Kingdom “working together” program (refer to footnote 12) and the approach adopted in New Zealand should be explored. Notably the United States does not appear to have had a positive experience from its attempts at adopting a more co-operative approach: see Braithwaite 2005 at 133 and 177. Also see HJ Aaron and J Slemrod, *The crisis in tax administration*, Washington: Brookings Institution Press, 2004.

THE REFORM OF PARTNERSHIP LAW AND TAXATION IN NEW ZEALAND

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While New Zealand law has provided for both general and special (limited) partnerships for many years, their use has gradually declined as limited companies have become the preferred vehicle for most business activities. This is presumably due to the limited liability afforded to the shareholders of companies. Possibly due to their declining use, New Zealand legislators have not given much priority to reform and modernisation of partnership law. As a consequence, New Zealand's partnership law (particularly with respect to "special" partnerships) is now outdated and not commensurate with international norms.

The venture capital industry is one industry that usually favours limited partnerships as a vehicle for investment due to their combination of limited liability and the ability to pass through losses to investors. As existing the rules for "special" partnerships in New Zealand are restrictive and outdated, the absence of a more suitable vehicle for venture capital has hindered the industry in New Zealand. To encourage the development of the venture capital industry, the Government has recently released proposals to amend New Zealand partnership law to allow for limited partnerships to be formed in New Zealand similar to those found in other jurisdictions.

In tandem with the limited partnership proposals, the New Zealand Government has recently released a Discussion Document containing proposals to reform the taxation of general partnerships and rules for taxing the new limited partnerships. The objective of this paper is to review these proposals for the reform of partnership law and the new partnership tax regime.

I INTRODUCTION

New Zealand, in common with many jurisdictions, allows two or more persons to carry on business jointly by way of a partnership. The humble partnership, once a common vehicle for many business ventures, appears to have fallen out of favour with the limited liability company becoming the preferred vehicle for most business ventures. This presumably is because of the limited liability afforded to investors by using a company and the advantages of a clear boundary being created between a business venture and its owners when a company structure is used.

The taxation rules applying to partnerships have not attracted much attention from New Zealand legislators for decades possibly reflecting their declining use as a business vehicle. Apart from the removal of the flow-through of tax losses to special partners in special partnerships in the 1986 and their reintroduction in 2005, the manner in which partnerships are taxed has been left untouched, in marked contrast to the substantial revision to the New Zealand income tax laws that have occurred over the past two decades. As a consequence, the rules applying to partnership taxation are long overdue for revision.

In June 2006 the New Zealand Government released a discussion document titled *General and limited partnerships –proposed tax changes*¹ ("Discussion Document")

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containing proposals for the reform of partnership taxation and for a new tax regime to apply to a new form of partnership being introduced known as a “limited partnership”. This was subsequently followed with the introduction of the Limited Partnerships Bill to Parliament in August 2007 providing for the enactment of those proposals into law. The objective of this paper is to review these proposals for the reform of partnership law and the new partnership tax regime as contained in the Limited Partnerships Bill.

II THE EXISTING STATE OF PARTNERSHIP LAW AND TAXATION IN NEW ZEALAND

A General Partnerships

Partnerships in New Zealand are currently governed by the Partnership Act 1908 which is closely modelled on the UK Partnership Act of 1890. This UK Act superseded earlier UK enactments and codified the common law relating to partnerships.

Under section 4(1) of the Partnership Act 1908, a partnership is defined as a relationship “between persons carrying on a business in common with a view to profit”. The term “business” is further defined in section 2 as “including every trade, occupation or profession” which is largely similar to the definition of a “business” for income tax purposes in section OB 1 of the Income Tax Act (ITA) 2004. Under section 4(2) of the Partnership Act 1908, membership of a joint stock company is specifically excluded from being a partnership.

The Partnership Act 1908 provides for two types of partnerships –general and special. All partners in a general partnership have joint and several liability for the partnership’s debts, while special partnerships have two types of partners being general and special ones, the latter enjoying limited liability in respect of their share of the partnership’s debts.

Unlike the law relating to the taxation of companies which is substantially codified, there are relatively few provisions to be found in the ITA 2004 covering the taxation of partnerships. This is probably due for several reasons. Firstly, the partnership is not a separate legal entity from the individual partners that comprise the partnership and therefore it can be viewed almost as a collection of sole traders. The second reason is that the partnership appears to have fallen out of favour as a business vehicle in favour of closely-held, private companies and presumably the lower number of partnerships has resulted in reduced attention from tax law reformers over the years. Thirdly, because the company is an artificial creation of statute, there is a greater need to have a comprehensive taxing code to deal with company taxation.

Partnerships are not defined in the ITA 2004 for income tax purposes except for the purposes of the resident withholding tax rules in section NF 10.² As a partnership is not a separate legal entity, it is not regarded as a taxpaying entity although partnerships are required to file a separate return of income annually to provide information as to how each individual partner’s income has been calculated.³

¹ Cullen, Hon Dr Michael and Hon Peter Dunne, *General and limited partnerships –proposed tax changes –A Government discussion document*, Policy Advice Division of the Inland Revenue Department, Wellington, New Zealand, June 2006.

² Under section NF 10(6) ITA 2004 the terms “partnership” and “partner” are given the same meaning as they have under the Partnership Act 1908.

³ Section 42(1), Tax Administration Act 1994.

Partnerships have characteristics which make them both attractive and unattractive as a business vehicle. Because partners are taxed on their individual shares of partnership income, they are treated as a “pass-through” for tax purposes (i.e. “fiscally transparent”). Therefore any losses derived by the partnership can be offset against any other income individual partners may derived from sources outside the partnership. This is in contrast to the position for most companies where losses must be carried forward to future income years.⁴ The downside of this “pass-through” is that each partners’ share of partnership income is taxed at rates applying to individuals, which at higher income levels will be at rates above the company tax rate.⁵ The ability of companies to retain earnings that have borne tax at a lower rate than the top individual marginal rate (33% vs 39%) favours the use of companies as a business vehicle.⁶

Another consequence of the “pass-through” treatment of partnership income is that income derived by the partnership retains its character in the hands of the individual partners as opposed to companies where income distributed to shareholders becomes a dividend. A consequence of this is that it currently allows certain types of income to be streamed to particular partners if so desired. For example, taxable income can be allocated to exempt partners or partners with accumulated tax losses, while foreign-sourced income or interest, dividends and royalties can be allocated to non-resident partners and capital gains streamed to resident partnerships facing high marginal tax rates. Such streaming is subject to only one constraint which is an anti-avoidance provision in the dividend imputation regime which prevents partnerships being used for imputation credit streaming arrangements.⁷

One major problem of the partnership is that if there is any change in the composition of the partners in the partnership (or even if existing partners vary their interests in a partnership) for tax purposes the existing partnership is deemed to have been dissolved and a new one formed. This results in the realisation of the partnership’s revenue and depreciable assets potentially giving rise to taxable income.⁸ This is in contrast to that of a company where a change in the shareholding does not result in any realisation of the company’s assets.⁹ On the other hand, such treatment for partnerships means that the partnership’s depreciable assets are more closely aligned to prevailing market values allowing corresponding depreciation claims to be more closely based upon current costs. Companies do not enjoy the same advantage.

The position in common law is that any amount paid as salary or wages to a partner is non-deductible for income tax purposes as the partner is working for the partnership as a part-owner not an employee. This was modified in 1985 with an amendment to the Income Tax Act 1976 which permitted a deduction for a partner’s salary or wages (now section DC 4 of the ITA 2004). A deduction is permitted for salary or wages paid to a working partner for amounts payable under a written contract of service provided the services are required for the carrying on of a business by the partnership. Deductions are not permitted where the partnership is carrying on some type of investment business

⁴ Except for a special class of company known as a “loss-attributing qualifying company” (LAQC).

⁵ Unless the partner is a company where the company tax rate will then apply.

⁶ The company tax rate is to be reduced from 33% to 30% from 1 April 2008 which widens the gap between the company tax rate and the top individual rate.

⁷ Section LB 1(4) and (4A), ITA 2004.

⁸ Changes in the composition of a partnership affects revenue assets such as trading stock, bad debts, depreciable capital assets and valuation of any work-in-progress.

⁹ Changes in shareholding may result in any tax losses carried forward from prior income years being forfeited and/or loss of credit balances in the company’s imputation credit account if the change of shareholding is of sufficient magnitude.

or activity.¹⁰ Section DC 4 was enacted to assist partnerships where there were differences in the types of contributions made by particular partners such as with agricultural partnerships where one partner contributed labour and expertise while the other non-working partners contributed capital.

B Special Partnerships

Special partnerships are provided for in Part II of the Partnership Act 1908 and have two types of partners – general and special. The liability of special partners in respect of the partnership’s debts is limited to the amount of their capital contributions.¹¹ General partners still have unlimited liability in respect of the partnership’s debts and may actively participate in the partnership’s management, while special partners may not participate in the management of the partnership if they are to retain their status as special partners.¹² A written partnership certificate is required which must be registered at the High Court and available for public inspection.¹³ In common with limited liability companies, there are requirements to keep books of account¹⁴ and special partners can be required to repay any amounts withdrawn from the partnership should the special partnership’s assets be insufficient to meet its debts.¹⁵ Unlike with general partnerships, special partnerships cannot be formed for an indefinite duration and are limited to an initial period of seven years, although they can be “renewed” at the end of the seven year period.¹⁶

There are also limitations upon the type of business a special partnership may undertake. Under section 49 of the Partnership Act 1908 they can be formed for “agricultural, mining, mercantile, mechanical, manufacturing or other business” but not for “banking or insurance” purposes.

Special partnerships became popular during the 1970s and early 1980s as a vehicle for tax shelter schemes involving agriculture, horticulture and film-making activities. Their popularity stemmed from their unique combination of limited liability for special partners and the ability to pass through tax losses. It is for the latter reason that, from 1 August 1986, the ability to pass through losses was removed and instead any losses were required to be carried forward in a similar manner to companies.¹⁷

Somewhat incongruously, new rules were introduced in 1993 which allowed certain closely-held companies (known as “qualifying companies” or “QCs”) to be taxed as partnerships (including the attribution of company losses to shareholders in some cases).¹⁸ Despite the introduction of this QC regime, the requirement for special partnerships to carry-forward losses was not reviewed despite the QC regime creating a “pass-through” entity with limited liability.

As part of a package to improve the climate for foreign participation in the New Zealand venture capital industry, the requirement for special partnerships to carry

¹⁰ Section DC 4(2), ITA 2004.

¹¹ Section 50, Partnership Act 1908.

¹² Section 52, Partnership Act 1908.

¹³ Sections 51, 54 to 56 Partnership Act 1908.

¹⁴ Sections 64, 66 and 67 Partnership Act 1908.

¹⁵ Section 60, Partnership Act 1908.

¹⁶ Section 57, Partnership Act 1908.

¹⁷ There was a “grand-fathering” provision for existing special partnerships provided no new capital was introduced into the partnership and its initial period of duration was not extended. Refer section HC 1 of the ITA 2004.

¹⁸ Explained in the next section.

forward tax losses was removed with effect from 1 October 2005. Losses from special partnerships can now be offset against a partner's other income but with one restriction. Special partnership losses cannot be carried forward to any future income years by a partner. Therefore if the partner does not have sufficient assessable income from other New Zealand sources in the same income year as the loss was derived from the special partnership, the loss is effectively forfeited.

The policy reason for this treatment is not clear (as it does not apply to losses attributed to shareholders of QCs) but may be designed to prevent double dipping of special partnership losses where the partner was a non-resident and obtained offset of the losses against foreign-sourced income offshore.¹⁹

C Qualifying Companies (QCs)

As a result of a recommendation from the Consultative Committee on the Taxation of Income from Capital,²⁰ in 1993 the Government enacted special rules for the taxation of closely-held companies. Until then, closely-held companies had been taxed in a similar way to widely-held ones which was not necessarily appropriate. The Consultative Committee took the view that closely-held companies were more akin to partnerships and recommended that special rules be introduced for shareholders of such companies to elect for them to be taxed in a manner similar to partnerships. Such companies are known as "qualifying companies" (QCs) and the tax regime applying to them is an elective one.²¹

Against the recommendations of public officials at the time, the Government also provided for a sub-set of qualifying companies (known as "loss-attributing qualifying companies" or "LAQCs") to be able to attribute tax losses to their shareholders rather than requiring them to be carried forward to future income years as is required for all other companies.

Since the enactment of the LAQC regime in 1993, LAQCs have become very popular and are now a common component in many tax planning arrangements. They have been widely used in many mass-marketed forestry plantation investment schemes (providing investors with limited liability and the ability to access tax losses) as well as for holding passive investments such as rental property. In the latter case it is difficult to see what a LAQC adds as limited liability is not usually an important issue for property investors.

Because a company is always a separate legal entity to its shareholders, the ability to distribute losses to shareholders has created some interesting tax planning opportunities with combined with the gross/global schema of the New Zealand ITA. Provided a gross receipt is assessable income, any expenditure or loss in producing that income is deductible irrespective of whether the amounts of taxable income and allowable deductions are grossly disproportionate. This also creates tax planning opportunities such as the sale of an owner-occupier residential property to a LAQC which is rented

¹⁹ Losses attributed to shareholders of LAQCs are able to be carried forward to future income years by the shareholders and are not forfeited as is the case for special partnerships. Similarly losses from general partnerships can also be carried forward despite the scope for "double-dipping" of tax losses across borders.

²⁰ A. Valabh, *The Taxation of Distributions from Companies*, Report of the Consultative Committee on the Taxation of Income from Capital, Government Printer, Wellington, November 1990.

²¹ Refer Holmes, K; "The Taxation of Closely-held Companies: Concepts, Legislation and Problems in New Zealand", *Australian Tax Forum*, Volume 9, Number 3, 1992, pp 323-353.

back to the shareholder.²² A rental loss is produced which is then attributable to the shareholder and can be offset against their other sources of income. What was previously a private expense (i.e. the cost of ownership of a private residential house) becomes tax deductible.²³

III EARLIER PARTNERSHIP TAX REFORM PROPOSALS

Difficulties associated with the taxation of partnerships were first highlighted by the Valabh Committee in their report *Key Reforms to the Scheme of Tax Legislation*²⁴ in 1991. In their report they identified a number of ambiguities arising with partnership taxation including:²⁵

- What constitutes a partnership for income tax purposes;
- How partnerships with both resident and non-resident partners are to be taxed including the tax status of payments made by such partnerships;
- Whether different types of income must be allocated proportionately to all partners or whether certain types of income can be streamed to certain partners;
- The tax status of foreign-sourced income derived by non-resident partners;
- The tax status of certain transactions between one partner and the partnership such as asset transfers and the payment of interest on capital contributions and loans to the partnership;
- The tax treatment arising from changes in the composition of the partnership (including entry and exit of partners) and the manner in which it is calculated; and
- The grounds for allowing a partnership to adopt a non-standard balance date which may be different to that of the individual partners.

The Committee noted that, in practice, many of the above problems did not arise due “to the adoption of a pragmatic approach to dealing with these issues by taxpayers and the Inland Revenue Department”.²⁶ However, they noted that having practice at variance with law was “not appropriate”, and if the Inland Revenue Department’s current practices were appropriate then they should be provided for in legislation. The Committee recommended that the tax treatment of partnerships should be largely continued as it was but with some minor changes to address some of the “technical inconsistencies in the legislation”.

Areas they felt needed to be addressed included a modification to the existing requirement to make an income tax adjustment in respect of revenue and depreciable assets when there was a variation in the composition of the partnership, the method of

²² The fringe benefit tax rules may also provide similar benefits where a LAQC provides a motor vehicle to one of its shareholders. What was previously a private motor vehicle now is a company one, and all the running costs become tax deductible even though the vehicle may be used entirely for private running. A tax advantage will arise where the deemed value of the fringe benefit is less than the actual costs of its provision. This typically occurs when the capital value of the car is low.

²³ The Commissioner has stated that the general anti-avoidance provision section BG 1 could apply to the sale and rent back of a private residential dwellinghouse, although the grounds upon which he could seek to invoke the section in such situations has not been made clear. If the house was purchased initially by the LAQC and then leased to the shareholders it is more difficult to see upon what grounds section BG 1 could be invoked.

²⁴ Consultative Committee on the Taxation of Income from Capital (Valabh Committee), Government Printer, October 1991.

²⁵ *Discussion Document*, paragraph 12.3, page 90.

²⁶ *Ibid.*

income allocation among partners, the tax status of interest paid to partners in respect of loans and capital contributions to the partnership, the treatment of partnerships with both resident and non-resident partners and the treatment of the existing special partnerships. Submissions were sought from interested parties.

Relatively few submissions were received in response to the 1991 report, and those few received supported relatively minor amendments to give statutory backing to existing practice. The Valabh Committee recommended in their report *Final report of the consultative committee on the taxation of income from capital*²⁷ that a limited number of amendments be made to the rules applying to partnership taxation pending a more fundamental review of partnership taxation. These recommendations were limited to modifying the rules regarding recognition of income upon the reconstruction of a partnership, providing the CIR with statutory authority to approve non-standard balance dates and for a definition of a partnership to be included in the ITA. Surprisingly, they did not recommend the introduction of any income allocation rule as manipulated income allocation between partners was not thought to be a major problem and that the existing anti-streaming provisions²⁸ for dividend imputation credits through partnerships were sufficient. Despite these recommendations, no amendments were made to the ITA, nor was this suggestion for a fundamental review of partnership taxation acted upon until recently, nearly 15 years later.

The Tax Review Committee (McLeod Committee) in its 2001 review of New Zealand's income tax regime²⁹ considered partnerships briefly and in general terms only. In considering entity taxation, the Committee recommended that, in principle, the income of all entities should be taxed at the marginal tax rates of its owners but tempering this recommendation was the recognition of the difficulty and complexity in achieving that objective with widely-held entities. In conclusion, it recommended that all widely-held entities be taxed as companies, and all closely-held entities (fewer than six owners) as partnerships. A consistent treatment was recommended to prevent "entity shopping" and as a policy rule to minimise the number of general entity treatments and to ensure they have clearly defined boundaries to minimise compliance costs.

IV LIMITED PARTNERSHIPS FOR VENTURE CAPITAL INDUSTRY

As a result of representations from certain sectors of the investment banking community (primarily the New Zealand Venture Capital Association), the New Zealand Government reviewed the existing special partnership regime contained in Part II of the Partnership Act 1908. In December 2003 the Government announced it would amend the existing special partnership legislation³⁰ with the objective of reducing the barriers for foreign investors investing in the New Zealand venture capital industry by legislating for a more suitable vehicle for such investment than the existing special partnership structure. This reform of partnership law would be in addition to two

²⁷ Consultative Committee on the Taxation of Income from Capital (Valabh Committee), Government Printer, October 1992.

²⁸ Section LB 1(4), (4A) and (4B), ITA 2004.

²⁹ R McLeod (Chairman), *Tax Review 2001 –Final Report*, Wellington, New Zealand, 2001.

³⁰ Hon Lianne Dalziel, Minister of Commerce, "Special Partnerships Need Updating", Media Release, 10 December 2003.

earlier amendments made to the ITA 2004 in December 2004 to enhance venture capital investment.³¹

The key issue being addressed is that the existing New Zealand special partnership rules are not consistent with those found in other jurisdictions (for example, the ones found in the United States and NSW in Australia) and create a barrier to foreign participation in the New Zealand venture capital industry. The New Zealand special partnership structure is unfamiliar to foreign investors and its status as a separate legal entity outside of New Zealand is uncertain. Therefore the new limited partnership vehicle will be closely modelled upon “an internationally recognised limited partnership model” such as the one found in New South Wales.

The major differences between the existing special partnerships and the new limited partnerships provided for in the Limited Partnership Bill are as follows:

- The vehicle will be called a “limited partnership” and the title of the partnership will be followed by the letters “LP” to be consistent with international practice.³²
- To overcome doubts whether special partners in a special partnership formed pursuant to Part II of the Partnership Act 1908 will be recognised as having limited liability outside of New Zealand, the new limited partnerships will expressly have a separate legal personality to that of their partners³³ and thus will be consistent with the Delaware (US) limited partnership model.
- Existing special partnerships have cumbersome registration requirements with significant risks arising to special partners if not carried out correctly. The new limited partnerships will have simplified registration procedures which will be administered by the Companies Office instead of the High Court.
- The Companies Office will maintain a limited partnership register which will disclose details of both the general and limited partners in addition to other information.³⁴
- Regulations will be issued pursuant to the new limited partnership rules which will provide “safe harbours” specifying what activities limited partners may undertake in respect of the limited partnership without deeming to be liable for the debts of the limited partnership in the same way as the general partners are.
- The existing special partnership rules are unclear on whether a general partner can become a special partner or vice-versa. Under the new limited partnership rules any person with legal capacity will be able to be a limited or general partner and both types of partners will be able to change their status from general to limited partners or vice-versa as well as hold interests in the partnership as both limited and general partners at the same time.³⁵ General

³¹ The first is the reinstatement of loss offsets from special partnerships to special partners from 1 October 2005. The second is an exemption in section CW 11B from New Zealand income tax for any gains derived from the sale of shares in certain New Zealand resident companies by any “qualified foreign equity investor”. A “qualified foreign equity investor” is defined in section CB 11(4) and is effectively an investor who is exempt from tax in the jurisdiction in which they are resident.

³² Clause 28(1), Limited Partnerships Bill 2007.

³³ Clause 10, Limited Partnerships Bill 2007.

³⁴ Clauses 47 to 52, Limited Partnerships Bill 2007. It was earlier proposed that the identity of the limited partners would not be publicly disclosed in the register however that was changed in the Bill and is now consistent with the disclosure requirements for limited liability companies.

³⁵ Clause 21, Limited Partnerships Bill 2007. However, if the limited partnership has only one general partner and one limited partner they cannot be the same person - Clause 8(2), Limited Partnerships Bill 2007.

partners will be prohibited from making a capital contribution to the limited partnership.³⁶

- Limited partnerships will have an indefinite life unlike with special partnerships which are currently limited to an initial period of seven years.
- In common with the current special partnerships, the new limited partnerships will not be able to carry on a banking or insurance business, however, they will have full legal capacity and will be able to do anything that a natural or other legal person can otherwise do.³⁷

As the flow through of losses to investors is an essential feature of any venture capital investment, it is important that the vehicle used to make such investment is recognised as fiscally transparent in both New Zealand and offshore. In this regard, LAQCs are an unsuitable vehicle to attract offshore participation into the New Zealand venture capital industry as they are uniquely a New Zealand creation by statute and are unlikely to be recognised as being fiscally transparent in offshore jurisdictions. QCs cannot have more than five shareholders which could also limit their usefulness as a suitable vehicle for financing in the venture capital industry.

As a result, the decision to enact new rules for the provision of limited partnerships in New Zealand has required a subsequent revision of the tax legislation applying to partnerships. The tax issues confronting both general and limited partnerships were canvassed in the *Discussion Document* and the resulting changes that have been decided upon are contained in the second part of the Limited Partnerships Bill.

V PROPOSALS FOR REFORM OF PARTNERSHIP TAXATION

In 1992 the Valabh Committee recommended that a fundamental review of partnership taxation be undertaken with the objective of providing a comprehensive code for the taxation of partnerships. The *Discussion Document* finally released in 2006 appears to fulfil that recommendation leading to the introduction of the Limited Partnerships Bill introduced in 2007. The Bill provides for the repeal of the existing subpart HD of the Income Tax Act 2004 applying to the taxation of partnerships (currently standing at only one section) and replacing it with a new subpart HD containing 12 sections. The clauses in the Bill appear to cover most of the key issues relating to partnership taxation although it in some parts they are brief and would be improved with greater statutory detail.

A *Aggregate Versus Entity Approaches to Partnership Taxation*

The Valabh Committee in its analysis of partnership taxation identified two approaches to partnership taxation.

The first was termed the “aggregate approach” under which each partner is treated as a fractional owner of all partnership assets. Therefore the partnership would not exist as an independent entity from its owners.

The second approach was termed the “entity approach”. Under this approach, each partner has an interest in the partnership (as opposed to a fractional interest in each of the partnership’s assets) being similar to an interest in a company. Income is calculated at the partnership level and each partner’s share of the net income flows to them.

³⁶ Clause 17(2), Limited Partnerships Bill 2007.

³⁷ Clauses 13 and 11 respectively, Limited Partnerships Bill 2007.

Under this approach, complicated adjustments would not arise when there was a change in the composition of a partnership.

The current manner in which New Zealand taxes partnerships is closest to the “aggregate approach”, although some aspects of it reflect the “entity approach”. In comparable jurisdictions such as Australia, the US and the UK both approaches are in use, sometimes in a hybrid manner. The *Discussion Document* proposed that a hybrid approach be adopted similar to current practice which appears to have been followed in the Bill.³⁸

B Recommended Changes to Partnership Taxation

1 Application and Scope of Changes

In the *Discussion Document* it was proposed that the new partnership tax rules would apply to four categories of partnership:

- Any partnership recognised as one under the Partnership Act 1908;
- A limited partnership registered as a “limited partnership” under the Limited Partnership Bill currently under consideration;
- All New Zealand resident partners of foreign general partnerships;
- All New Zealand resident partners of a foreign limited partnership providing the partnership has at least one general partner; is not publicly traded and does not have a separate legal personality.³⁹

Under the Limited Partnerships Bill, partnerships falling within one of the four categories above will be accorded a “flow-through” treatment for New Zealand tax purposes on the same basis as was outlined in the *Discussion Document* above. The new limited partnerships will be eligible for the “flow-through” treatment despite having a separate legal personality. This treatment is proposed on the grounds of consistency with prevailing international practice⁴⁰ and represents a departure from the current New Zealand treatment where any entity that has a separate existence or personality from its owners is taxed as a company.⁴¹ This “flow-through” treatment, however, will be restricted to New Zealand-registered limited partnerships and any foreign entity that has a separate legal personality or is publicly traded will not be eligible for “flow-through” treatment under New Zealand tax law. This differential treatment is justified in the *Discussion Document* on the grounds of maintaining consistency with new provisions governing foreign tax credits for hybrid entities in section CD 10C.

2 Flow-Through of Income and Expenditure

As the reform proposals are based upon the “aggregate approach”, one of the key recommendations is for specific rules as to how income and expenditure can be allocated among partners. While there are doubts as to the legal grounds for doing so, it

³⁸ Paragraph 3.11, page 12.

³⁹ *Ibid*, page 13.

⁴⁰ *Ibid*, paragraph 4.15, page 16. It is noted in paragraph 4.16 that this will require a change to the definition of “company” for tax purposes to specifically exclude New Zealand-registered, limited partnerships.

⁴¹ Under section OB 1, ITA 2004, a “company” is defined as “a body corporate or other entity that has a separate legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere”.

currently appears possible to allocate different types of partnership income among different partners in a manner that minimises New Zealand income tax payable.

Under the Limited Partnerships Bill all partners in a partnership for tax purposes will share proportionately in the partnership's income and deductions according to their interest in the partnership and therefore the tax efficient streaming of income and deductions outlined above would no longer be possible.⁴² This proportionate allocation rule would also apply to both taxable and non-taxable income as well as to the allocation of foreign taxes credits among partners.

The *Discussion Document* examined the issue of where there is a change in the composition of a partnership, deductible expenditure incurred by a retiring partner is not deductible to an incoming partner. It is proposed that any expenditure incurred by an incoming partner from the date they enter the partnership would be deductible. This amount, however, would have to be appropriately quantified. Two methods to deal with such quantification were advanced. The first, termed the "closed-off approach" would require income and expenditure to be calculated up to the date of change in the composition in the partnership being in effect preparation of part-year financial statements. This approach, while providing an accurate apportionment of income and deductions to incoming and outgoing partners, would have high compliance costs, and for this reason a second alternative, termed the "simplified apportionment approach" is proposed as an option.

Under this latter option, a weighted average would be taken based upon the existing partner's interest in the partnership for the part of the year they were a partner. Deductible expenditure would be calculated on this basis. This method would be less costly to apply and in many circumstances would not be likely to produce materially different results to the other method. Unfortunately the Limited Partnerships Bill does not make it clear which approach is to be followed and merely authorises a deduction to partners of deductible expenditure incurred by the partnerships even if they were not partners at the time the expenditure or loss was incurred.⁴³ This is an issue which will require further attention before the Bill is passed.

3 *Transactions Between Partners and Partnerships*

This issue was highlighted by the Valabh Committee as one where existing practice was inconsistent. Interest paid on loans by a partner to the partnership have always been deductible to the partnership as has rent paid in similar circumstances, while interest paid on a partner's capital contributions was not as were salaries paid to partners. Salaries paid to partners subsequently became deductible to partnerships from 1985 provided certain conditions were met as specified in section DC 4. These conditions are:

- A written contract of service exists;
- The amounts payable are specified in the contract of service (other than by way of bonus);
- The business of the partnership must not be one of investment of money of the holding of or dealing in shares, securities, estates or interests in land.⁴⁴

In the *Discussion Document* it was proposed to retain these rules. While there is an existing anti-avoidance rule in section GD 10 where a partner rents a property they own

⁴² Section HD 2(2), Clause 116, Limited Partnerships Bill 2007.

⁴³ Section HD 2(3) in Clause 116 of the Limited Partnerships Bill 2007.

⁴⁴ There is also an anti-avoidance provision in section DC 3 which limits a tax deduction for pensions paid to a former partner or their surviving spouse to "reasonable amounts".

to the partnership, the rental must be commensurate with market rates, it was proposed to introduce a “market value” rule so that all transactions between partners and their partnerships must be conducted at prevailing market rates for tax purposes. Such a rule would apply where a partnership asset was sold to a partner or where an asset was introduced to the partnership by a partner. A deemed disposition would occur and any gain or loss would be required to be brought to account for tax purposes. This proposal is followed in the Limited Partnership Bill in a new section GD 16 will deem for tax purposes that all transactions between partnerships and their partners are transacted at market rates.

4 *Changes To Partnership Composition*

One of the biggest problems with the existing partnership tax regime is the need to make tax adjustments every time there is a change in the composition of the partnership. In many cases, the resulting compliance costs can be disproportionate to the amount of income arising. This issue is probably more problematic for larger partnerships (as found in some professions) than for smaller ones.⁴⁵

It is also uncertain whether the current tax practice upon the dissolution or reconstitution of a partnership is consistent with existing legislation. This is because it is unclear whether in a reconstitution the assets of the old partnership are being sold in their entirety to the new partnership or whether there is only a partial disposition of partnership assets between those partners retiring and entering the partnership. The *Discussion Document* proposed a solution which could best be described as a “*deminimis* compromise” using again using a hybrid of the “aggregate” and “entity” approaches to partnership taxation.

The *Discussion Document* proposed that the “entity” approach be adopted subject to a *deminimis* test. If the difference in the consideration received by the partner for their overall interest in the partnership and their share of net partnership assets was below \$20,000⁴⁶ the changes in the composition of a partnership would be treated as a transfer of an interest in the net assets of the partnership rather than individual interests in each of the partnership’s assets. This would overcome the need to recognise income or losses upon reconstitution of the partnership. If the *deminimis* test was not met (i.e. where partnership assets had appreciated significantly), it would be mandatory to undertake a “revenue account adjustment” and recognise income upon the retirement of a partner. If a partner was eligible for the *deminimis* exemption they would have the option of being able to undertake a “revenue account adjustment” if they so desired.

The “revenue account adjustment” would be calculated according to the retiring partner’s share in the gains/losses if all revenue account assets were sold directly to the new partner. This would include the disposition of assets such as financial arrangements, trading stock and depreciable assets. It should be noted that the “revenue account adjustment” would not be the same as the calculation for the \$20,000 *deminimis* test above, as the latter would also include non-taxable capital amounts while the former only revenue amounts.

⁴⁵ Many large professional partnerships use a service company to hold depreciable assets to overcome the need to undertake deemed part disposals and acquisition of such assets each time there is a change in the composition of the partnership.

⁴⁶ *Discussion Document*, paragraph 9.19, page 47. Anti-avoidance provisions are proposed to prevent the sale of a partnership interests through a series of partial sales to take advantage of the \$20,000 limit. It would also be required that the partnership interest is held by the partner on capital account.

These proposals are developed further in the Limited Partnerships Bill. A partner will only have to account for tax on retiring from a partnership if the amount of the disposal proceeds exceeds the total tax book value of the partner's share of partnership property by more than \$50,000 (rather than the \$20,000 proposed in the *Discussion Document*). Furthermore, even if the difference is greater than \$50,000, a retiring partner will not have to account for tax on specific types of gains if they are below certain specific *deminimis* limits. These limits are as follows:

- (i) Trading stock if the annual turnover of the partnership is \$3 million or less.⁴⁷
- (ii) Depreciable tangible property if the historical cost of that property held by the partners of the partnership is \$200,000 or less.⁴⁸
- (iii) Financial arrangements, provided the partnership is not in the business of deriving income from financial arrangements and the financial arrangement has been entered into as a necessary and incidental part of the partnership's business.⁴⁹

In addition, the Valabh Committee in 1992 also suggested that where there was a substantial change in the composition of a partnership (more than a 50% change in the composition of the partnership in any 12-month period) a revenue account adjustment would also be required for all partners. While the *Discussion Document* made no recommendation on this issue but instead sought submissions from interested parties,⁵⁰ this proposal has subsequently been incorporated into the Limited Partnerships Bill.

The *deminimis* provisions outlined above will all be subject to an overriding rule that where there is a change of 50% or more in the ownership of a partnership in any 12-month period, dissolution of the whole partnership is deemed to occur.⁵¹ As a result, all partnership property is deemed to have been acquired by the partnership at prevailing market values even for partners who have not retired. The objective of this provision is to "prevent large asset transfers that give rise to significant deferral of tax liabilities".⁵² However, this provision appears penal to existing partners and the Bill is likely to attract a number of submissions on this issue.

There is also one further *deminimis* provision for "small partnerships". A "small partnership" is defined as a general partnership with five or fewer partners none of which are companies or other partnerships. Such small partnerships can ignore revenue account adjustments in respect of trading stock, depreciable tangible property and financial arrangements even where the \$50,000 threshold is exceeded. They are still subject to the 50% change in composition rule, however. Given that a great number of partnerships in New Zealand probably fall within the "small" category, this is a significant concession.

Where a retiring partner is eligible for relief under one of the *deminimis* exemptions, the incoming partner is deemed to have acquired their share of the partnership property at the retiring partner's tax book values.⁵³ This could present a problem for the incoming partner as when a revenue account asset was subsequently sold they would be liable to tax upon the gain including that portion which was derived prior to them entering the partnership. In essence part of their capital contribution to the partnership

⁴⁷ Section HD 6, Clause 116, Limited Partnerships Bill 2007.

⁴⁸ Section HD 7, Clause 116, Limited Partnerships Bill 2007.

⁴⁹ Sections HD 8-9, Clause 116, Limited Partnerships Bill 2007.

⁵⁰ *Ibid*, paragraphs 9.19-9.20, page 50.

⁵¹ Section HD 3, Clause 116, Limited Partnerships Bill 2007.

⁵² *Hon Peter Dunne, Minister of Revenue, Limited Partnerships Bill -Commentary on Parts 5 and 6 of the Bill -associated tax changes*, at page 16.

⁵³ Sections HD 6(5), 7(5), 8(5) and 9(5); Clause 116, Limited Partnerships Bill 2007.

would become taxable to them –something that most taxpayers would find undesirable unless the amounts were trivial.

Where a “revenue account adjustment” is made upon the retirement of a partner it is subsequently necessary to determine the revised cost of those assets to the partnership. In the *Discussion Document* it was proposed to allow taxpayers a “cost base allocation election” which would permit the opening values of the partnership assets to be apportioned among the partners at the effective amounts they individually acquired them for. Thus where a share in a depreciable asset was acquired by an incoming partner at a higher price than that paid for by existing partners, the incoming partner would be able to claim higher depreciation in respect of that depreciable asset than would the existing partners. While this would address the problem where the incoming partner risks having their capital contributions being converted into taxable income, the resulting complexity in having to track each partner’s separate interests in the partnership’s individual revenue assets is likely to give rise to high compliance costs.

The provisions of the Limited Partnerships Bill do not explicitly require that each partner’s share in partnership property will have to be tracked separately. However, as section HD 2(1)(b), Clause 116 provides that:

a partner of partnership is treated as holding property that a partnership holds, in proportion to the partner’s partnership share, and the partnership is treated as not holding the property

The effect is that each partner’s share in partnership property will have to be tracked separately with the attendant compliance costs. This represents a departure from existing practice whereby if the cost base of a partnership asset is adjusted through the change in the composition of the partnership, the remaining partners enjoy the benefit of that variation (for example through increased depreciation charges) even though they have not been required to undertake a revenue account adjustment in respect of that asset.

5 *Distributions and Dissolutions of Partnerships*

Under the current tax treatment of partnerships, distributions of partnership assets to individual partners are not a taxable event and this will continue as such sums represent either previously taxed income or withdrawal of capital from the partnership. This treatment is one that distinguishes the partnership from companies. Distributions to partners of limited partnerships will be treated the same way. Where a limited partner had guaranteed a limited partnership’s debts, any reduction of that guarantee will be treated as a distribution to the partner of the same amount.

Under current partnership law, there is automatic dissolution of a partnership upon the death or bankruptcy of a partner unless the partnership deed provides otherwise.⁵⁴ While it was earlier proposed that this approach be changed to be consistent with the entity approach for partnership taxation and for other grounds be specified such as upon court order or unanimous agreement between the relevant partners, the Limited Partnerships Bill does not contain any provision to change the current law regarding dissolution of general partnerships. For the new limited partnerships, there is no automatic provision for dissolution of the partnership upon death or bankruptcy of a partner unless the deceased partner was a limited partner and is not replaced in the partnership within a specified period of time. The bankruptcy of a sole general partner

⁵⁴ Section 36, Partnership Act 1908.

or their legal incapacity is however grounds for the Court to appoint a liquidator, but it is not mandatory for the Court to do so.⁵⁵

6 *Limited Partnership Tax Losses*

A key part of the *Discussion Document* was the proposal that the new limited partnerships would be accorded flow-through of tax losses to both limited and general partners despite them being regarded as a separate entity. However, the amount of tax losses flowing through to the limited partners would be limited to their investment in the partnership. This was proposed on the grounds that the amount they have invested in the partnership is the maximum amount they have at risk (given that they have limited liability) and therefore the total amount to be offset in respect of their interest in the partnership should be limited to that amount. Any limited partner's share of partnership losses in excess of their investment would not be passed through, but instead carried forward and offset against any assessable income the partnership may derive in future income years. This treatment was further justified on the grounds that:

The absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangement or schemes whereby small amounts of capital are invested to get access to larger net tax losses. This could result in abuse of the limited partnership rules and in actions that are contrary to their intent. This may potentially create large fiscal costs to the government.⁵⁶

It was also noted that the rules are "consistent with the treatment provided by other countries" such as Australia and the US.⁵⁷

The issue underlying the decision to limit the flow-through of losses to limited partners is to prevent a flow-through for deductible expenditure financed by money borrowed by the partnership in which the limited partners had limited liability for. Many abusive mass-marketed tax avoidance schemes have relied upon the use of limited-recourse financing to artificially inflate deductible expenditure. Concerns about such arrangements led the New Zealand Government to introduce deferred deduction rules in 2003 to limit such abuses.⁵⁸ These rules limit deductibility of expenditure where it has been funded by limited-recourse loans and aim to prevent a deduction unless a taxpayer has borne an economic loss. The rules are not specific to any type of business vehicle.

The *Discussion Document* contained a formula that would determine how the loss flow-through limitation would apply. It would apply only to the limited partner's "basis" (or adjusted investment) in the partnership.⁵⁹ The formula ignored any capital gains or losses the partnership may have derived which was unrealistic, although in a subsequent paragraph it was suggested that such amounts should be taken into account when calculating a partner's "basis" to "accurately reflect a partner's net investment in the partnership that is at risk" and to "decrease the disparity between the tax treatment applying to a partner investing through a partnership vehicle and an individual investing directly".⁶⁰

The formula for calculating a partner's "basis" in the Limited Partnerships Bill⁶¹ does take into account capital gain and loss amounts and is as follows:

⁵⁵ Clauses 75 to 79, Limited Partnerships Bill 2007.

⁵⁶ *Discussion Document*, paragraph 8.2, page 34.

⁵⁷ *Ibid*, paragraph 8.3, page 34.

⁵⁸ Refer sections GC 29 – 31, ITA 2004.

⁵⁹ *Ibid*, paragraph 8.12, page 36.

⁶⁰ *Ibid*, paragraph 8.16, page 38.

⁶¹ Section HD 11(3), Clause 116, Limited Partnerships Bill 2007.

	Investments	\$A
<i>less</i>	Distributions	B
<i>plus</i>	Income	C
<i>less</i>	Deductions	D
<i>less</i>	Disallowed Amount	<u>E</u>
	Limited Partner's Interest	<u>\$F</u>

Where:

Investments = the aggregate of the market values of any contribution of a partner at the time of the contribution, amounts paid by the partner to the partnership for any financial arrangements to which the partnership is a party and any guaranteed amount;

Distributions = the aggregate of the market values of any withdrawals by the partner from the partnership and amounts paid to the partner under financial arrangements to which the partnership is a party;

Income = the aggregate of prior year's income, capital gains derived by the partnership and assessable income the partner has derived in prior years from goods and services they contributed to the partnership if not accounted for previously;

Deductions = the aggregate amount of any partnerships losses passed through in prior income years, any capital losses suffered by the partnership and deductions taken in prior income years in respect of assessable income from goods and services they have contributed to the partnership if the deduction has not been included with "distributions" earlier; and

Disallowed Amount = any investments made within 60 days of the end of the income year if those investments are distributed or withdrawn within 60 days after the end of the income year.

Recognition of capital gains when determining a limited partner's "basis" will increase the capacity to flow-through losses to the limited partners while recognition of capital losses will have the opposite effect.

In the *Discussion Document* it was suggested that some form of anti-avoidance rule may be required to prevent abuses from partner's shifting their status back and forward between these two categories. This has not been followed in the Limited Partnerships Bill, however, there is another anti-avoidance provision to prevent the creation of an artificially high "basis" at year-end when the loss pass through is calculated. A limited partner's "basis" will be reduced by the amount of any increase that arose within the previous 60 days before year-end which was subsequently withdrawn within 60 days after year-end which is incorporated in the above formula.⁶²

The *Discussion Document* also considered how the new tax rules for limited partnerships could compare with the existing LAQC rules. It was suggested that the proposed loss limitation rules for the new limited partnerships could be side-stepped if LAQCs were to be general partners in a general partnership. In such an arrangement, limited liability could be enjoyed along with full flow-through of losses. It was noted:

The government recognises that these structures could be used to circumvent the policy intent behind the proposed loss limitation rules. The issue may be considered further in a future review of the LAQC rules.⁶³

While there is potential for the above arrangement to achieve the same outcome as the proposed limited partnership but with full loss flow-through, it is only likely to work where all investors are New Zealand resident. This is because it is highly unlikely New Zealand LAQCs will be treated as loss a flow-through entity in an offshore jurisdiction

⁶² Section HD 11(5)(e), Clause 116, Limited Partnerships Bill 2007.

⁶³ *Ibid*, paragraph 8.30, page 42.

as they are a unique creation of New Zealand statute. The new limited partnership rules are being introduced to facilitate offshore investment into New Zealand for the key reason that such partnerships are likely to be treated as “fiscally transparent” in offshore jurisdictions. There is little assurance that this would occur with an alternative structure using LAQCs and therefore the Government’s concerns do not appear to have much validity.

7 *International Aspects of the Flow-Through Treatment*

As partnerships will continue to be taxed as “flow-through” entities, there are a number of subsequent issues arising in respect of cross-border transactions where the partnership derived foreign-sourced income and/or some of the partners are non-resident.

Where a partnership derives foreign-sourced income, all partners will be required to have any foreign tax credits derived by the partnership allocated to them in proportion to their share of partnership income. If a partner happens to be a New Zealand company, the company will be liable to make dividend withholding payments in respect of any foreign dividends they may receive and may also be eligible for underlying foreign tax credits (UFTC) in some situations.

Where a partnership has both resident and non-resident partners, the scope of New Zealand to tax that portion of partnership income allocated to the non-resident partners is dependent upon New Zealand’s source rules in section OE 4. A non-resident partner’s share of New Zealand sourced interest, dividends and royalties will be subject to non-resident withholding tax (NRWT) or the approved issuer levy (AIL), and to tax relief in respect of New Zealand-sourced dividends under the foreign investor tax credit (FITC) regime.⁶⁴ Consistent with international tax principles, a non-resident partner would not be subject to New Zealand tax on any foreign-sourced income derived by the partnership.

If the non-resident partner is entitled to protection under one of New Zealand’s DTAs, the general position is that the activities of the partnership in New Zealand will constitute a permanent establishment for the business profits article of the DTA. This approach is supported by paragraph 19.1 of the Commentary to Article 5 of the *OECD Model Tax Convention on Income and on Capital* which recognises that the activities of a fiscally transparent entity such as a partnership may constitute a permanent establishment in respect of income derived by non-resident partners.

Because under New Zealand tax law partnerships are “fiscally transparent”, it is not possible to classify them as resident or non-resident as that classification is applicable only to their individual partners. Therefore in determining whether DTA benefits are applicable, the DTA has to be applied to each individual non-resident partner’s share of income. The absence of a residence status for partnerships makes it difficult to apply some of the sources rules in section OE 4(1) particularly subsections (n), (r) and (s).⁶⁵ The Vallabh Committee had considered the option of introducing a rule that where resident partner’s aggregate interests in the partnership were 50% or more, the partnership would be treated as being a wholly-resident entity for the purposes of the source rules only. The *Discussion Document* left this matter open for submissions and made no recommendation as to whether this recommendation should be adopted.

⁶⁴ Refer subpart LE, ITA 2004.

⁶⁵ Applying to interest in respect of money lent outside New Zealand, royalties and lease payments in respect of leases for personal property.

The Limited Partnerships Bill however follows the Vallabh Committee's recommendation and contains provisions to clarify this area of law by providing that for the purposes of New Zealand's source rules that a partnership will be treated as a resident taxpayer if:

- (i) The partnership is a limited partnership registered under the Limited Partnerships Act 2007;
- (ii) For a general partnership if 50% or more of the partner's interests in capital or by value are held by New Zealand residents; or
- (iii) The centre of management of the partnership is in New Zealand.

C The Future of LAQCs

As discussed earlier, the *Discussion Document* noted that the proposed loss limitation rules for the new limited partnerships could be circumvented if LAQCs were used in combination with a general partnership. In a media release dated 6 September 2006,⁶⁶ announcing that legislation covering partnership taxation would be introduced and passed in 2007 after consideration of submissions received in respect of the *Discussion Document*, further reference was made to the continuing status of LAQCs. The Government acknowledged that it had received many submissions on the LAQC issue but left it open whether they would give further consideration to revision of the LAQC regime:

While this is clearly a live issue, it would be premature to consider the future of the LAQC rules until we know the final legislative form of the partnership tax changes. Once that is clear, there will be consultation on the LAQC rules.⁶⁷

This announcement has done little to allay fears that the new limited partnerships rules will be used as an excuse to repeal the LAQC regime, even though the two vehicles are more mutually exclusive rather than overlapping. The Limited Partnerships Bill contains no references to the LAQC regime and whether the review alluded to above is likely to occur after the Limited Partnerships Bill is passed is not clear.

VI ANALYSIS

A Clarification of General Partnership Tax Rules

The tax provisions contained in the Limited Partnerships Bill will address many of the concerns the Vallabh Committee raised about partnership taxation, in particular that many of the CIR's existing practices with respect to partnership taxation are not supported by current legislation.

One of the changes proposed will make tax-efficient income streaming among partners of a partnership no longer possible. The current opportunities for tax-efficient income streaming arise in fairly limited situations such as where a partner is a non-resident or is tax-exempt. It is suggested that relatively few partnerships are likely to have partners falling within either category and that the additional compliance costs arising by introducing an income allocation rule is not warranted when compared to the aggregate tax avoidance risk. Income allocation rules for partnerships may also interfere in a partnership's ability to organise its affairs in the most efficient manner.

⁶⁶ Hon Peter Dunne, Minister for Revenue, "Partnership tax changes planned for 2007 bill", Media Release, 6 September 2006.

⁶⁷ *Ibid.*

The reform of the tax consequences upon the reconstitution of a partnership are not without problems although it is a complex issue whatever way it is dealt with for tax purposes. While the *deminimis* provisions proposed have their merits, they are not without problems. Firstly, to determine whether a partnership falls within the *deminimis* exemption or not, the partnership will still have to undertake calculations so it is debatable how much compliance costs are reduced through the *deminimis* exemption. If the exemption is claimed, the consequences for the incoming partner are unattractive. Part of the consideration they will pay to enter the partnership will end up becoming taxable due to unrealised gains on partnership assets existing at the time they enter the partnership. Therefore unless the consideration they pay to enter the partnership is adjusted for the tax payable on unrealised gains, they will be worse off. To make such an adjustment will require calculations which again would appear to undermine the objective in having a *deminimis* limit on grounds of compliance cost reduction. If a partnership is ineligible for the general *deminimis* exemption (i.e. the \$50,000) but qualifies for one of the specific ones (i.e. trading stock, depreciable tangible property etc.) the incoming partner will be deemed to have acquired their share in the partnership assets at a mixture of old and current values which must surely increase future compliance costs.

If a partnership is ineligible for above the *deminimis* limit of \$50,000 (or makes an election for an adjustment if below the limit or if there is a change in the composition of the partnership of more than 50% in any 12 month period) there is the consequence that the partners will have different carrying values for their individual share in the partnership's assets. Unfortunately there is no easy solution to this problem unless the partnership is taxed on a separate entity basis (as opposed to the hybrid basis used in the *Discussion Document*). The only exception made is for "small partnerships" being ones with five or fewer partners.

B Flow-Through For New Zealand Limited Partnerships

One anomalous proposal in the *Discussion Document*, which has been subsequently followed in the Limited Partnerships Bill, is to not allow the flow-through of losses from foreign-registered, limited partnerships to New Zealand-resident partners where those partnerships are separate legal entities in the jurisdiction where they are resident, even though almost identical New Zealand-registered, limited partnerships will be treated as "flow-through" entities. It seems almost naive to permit flow-through of losses from New Zealand-registered limited partnerships with a separate legal entity and expect foreign jurisdictions to do the same while denying similar foreign-registered limited partnerships with the same treatment. It remains open whether foreign jurisdictions may decide to discriminate against New Zealand-registered limited partnerships in the same way. This could prove a barrier to the new limited partnerships becoming a suitable vehicle for foreign participation in the New Zealand venture capital industry.

C Limited Partnership Loss Offset Rules

Another controversial part of the *Discussion Document* was the loss limitation rule for the new limited partnerships which has been carried over without change to the Limited Partnerships Bill. The underlying principle of the proposal is that taxpayers should not be able to obtain a deduction for an amount they are economically at risk for.

If that principle is to be applied properly, the partner's interest would need to be valued at market values on a regular basis. This is because any unrealised gains (whether taxable or not) are essentially at risk in the partnership. To make such an allowance for tax purposes could give rise to very high compliance costs, although there are precedents elsewhere in the ITA 2004 where unrealised gains are taken into account (as for example with the thin capitalisation rules) although they are likely to apply to much larger and more sophisticated taxpayers. The proposal to include in the partner's "basis" calculation the amount of any guarantees for debts owed by a limited partnership is also problematic on practical grounds.

Of the arguments advanced in the *Discussion Document* for limiting the loss flow-through to limited partners, only the consistency with overseas practice has any validity. The proposals overlook that there are already two tax provisions that address the issue of deductibility of expenditure where it has been financed by borrowed money. The first is the deferred deduction rule⁶⁸ which applies where limited-recourse loans are used to finance deductible expenditure in certain situations. Secondly, under the financial arrangement rules (in subpart EX) where debt is forgiven, income is triggered under the base price adjustment (section EX 31). Therefore the effect is that where expenditure has been financed by a loan which is not repaid, the amount of the deduction is effectively reversed. This provision appears to adequately address the mischief already and further provisions do not seem necessary.

D The Future of LAQCs

It is unfortunate that the introduction of the new limited partnership rules has raised doubts about the continuation of the LAQC regime. Limited partnerships and LAQCs are vehicles for different types of ventures. Limited partnerships require two different types of investor –being general and limited partners. The limited partners receive limited liability only if they do not directly participate in the management of the partnership. Shareholders in a company do not have their limited liability revoked if they also participate in the management of the company, although directors can become liable for a company's debts if they allow it to trade insolvently irrespective of whether they are also shareholders or not. Therefore the new limited partnership structure (with its limitation upon the pass-through of losses) is not a perfect substitute for the LAQC. The limited partnership is an unsuitable vehicle to operate a small business through where the limited partner could inadvertently participate in the management of the partnership's business and lose their limited liability.

The LAQC is based on the premise that a closely-held company is not that dissimilar to a general partnership and should be taxed as such, while the limited partnership is more suitable where there is explicit separation of investors and management such as with a widely-held company. The fact that there is no proposal to limit the number of limited partners in a limited partnership where there are tight limits upon the number of shareholders in a LAQC is proof that the two vehicles are aimed at different circumstances.

The alleged mischiefs arising from the use of LAQCs stem from the adoption of the new core provisions in 1993 where the New Zealand income tax regime was placed explicitly on a gross/global basis. Provided any gross receipt received by a taxpayer is taxable income, then any expenditure incurred in producing that income is deductible irrespective that the expenditure is disproportionately large in comparison to the gross

⁶⁸ Sections GC 29 to 31, ITA 2004.

income and that the activity may never produce net taxable income. Because of the global nature of the New Zealand income tax regime, any loss can be automatically offset against other sources of income (e.g. employment income). Revision of the gross-global basis underpinning the New Zealand income tax regime would appear to be a more appropriate area to review rather than discontinuing LAQCs. Another option would be to consider introducing uneconomic business rules that would quarantine losses from uneconomic activities.

Withdrawal of the LAQC regime will also lead to many LAQC shareholders winding-up these companies and placing the assets in other vehicles such as trusts and general partnerships. While this may lead to some claw-back of depreciation and attendant transaction costs, the problem of rental property loss offsets will remain due to the gross/global nature of the New Zealand income tax regime.

VII CONCLUSION

The decision to reform the partnership tax regime was made for two reasons. The first was in response to the Valabh Committee's recommendation from the early 1990s for a comprehensive review of partnership taxation and the second from the decision to introduce a new limited partnerships regime for the incorporation of limited partnerships in New Zealand, with the latter in response to lobbying from the venture capital industry to attract foreign investment into the New Zealand venture capital industry.

The proposed changes have been widely canvassed over a long period. The proposed changes to partnership taxation and the new limited partnership rules provide a welcome clarification of the taxing regime applying to partnerships and for an internationally consistent basis for the taxation of the new limited partnerships.

There are parts of the Limited Partnership Bill that would benefit from further consideration. Firstly, it is incongruous to not extend the same flow-through treatment to New Zealand limited partners of foreign registered limited partnerships where they are separate legal entities. Secondly, the rules for restricting the pass-through of losses to limited partners of limited partnerships are complex and probably unnecessary given existing provisions of the ITA (such as the deferred deduction rules) to address the problem of artificially created losses. Lastly, the proposals for the tax treatment upon the reconstruction of a partnership need further review as they are still likely to give rise to high compliance costs and complexity.

JUST WHAT IS A 'RESIDENCE FOR GST PURPOSES?'

TONY VAN DER WESTHUYSEN*

I INTRODUCTION

It is difficult to imagine an area of Goods and Services Tax (GST) where mistakes are more costly than those involving supplies of real property. Dealings in real property typically involve very large sums of money coupled with relatively low margins, so the GST component may well be greater than the margin in most (if not all) real property transactions. Treating a taxable supply as non-taxable or accounting for GST in a tax period later than the one in which attribution actually occurred is likely to prove disastrous for the supplier, since it is entirely possible that the penalty alone could exceed the profit made on the sale.

The situation is complicated by the fact that supplies of real property, unlike most other assets types, may be "taxable supplies", "GST-free supplies", "input taxed supplies" or supplies that fall outside the GST legislation altogether. No less troubling has been the apparent confusion about how to treat supplies of *residential* real estate. This is of significance because sales of residential properties comprise a significant proportion of all real estate sold in Australia.¹ The GST treatment of residential property would be of considerable concern to a purchaser because GST on residential property will not ordinarily give rise to input tax credits. This means that any GST would simply raise the price of the property, since it is only in a small number of cases that a purchaser of residential property might be entitled to an input tax credit for any GST included in the price.²

Problems with the GST treatment of residential property have arisen because of two main factors. The first is the absence of a clear and unambiguous definition of the term "residential premises" in s 195-1 of *A New Tax System (Goods and Services Tax) Act 1999* (GST Act). Despite two attempts by the Commissioner to explain what he thinks the term means,³ courts have yet to deal satisfactorily with the issue. The second is the use of the phrase "to be used predominantly for residential accommodation" in s 40-35(2) and s 40-65(1).

Following a recent Full Federal Court decision,⁴ the government released legislation to change the definition of residential premises. The effect of the court's interpretation of the old definition was that strata-titled units and other types of short-term accommodation would fall outside the definition of residential premises. Accordingly, sales of these types of accommodation might attract GST and, more importantly, might give rise to input tax credits for purchasers. The amendments were designed to prevent this outcome, while at the same time preserving the result of the Full Federal Court

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¹ Australian Bureau of Statistics 8752.0 - Building Activity, Australia, Jun 2007

² Residential property would generally be used as an individual's private residence (in which case input tax credits are denied under s 11-15(2)(b)) or let as an investment property (in which case input tax credits are denied under s 11-15(2)(a)). It is only where the purchaser intends to use the property predominantly as a place of business that input tax credits might be available.

³ Rulings GSTR 2000/20 and GSTR 2003/3.

⁴ *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) 214 ALR 190.

decision.

The intention behind the amendments was to make it clear that leases of individual units for short-term stays to individuals or on longer-term leases to hotel operators would not be taxable supplies.⁵

This article suggests that the amendments fail to address some of the more fundamental difficulties present in the treatment of residential premises. In particular, it suggests the definition of "residential premises" is still flawed in its treatment of vacant land and that problems will remain despite the changes.

To explain the impact of the Full Federal Court decision and the motivation behind the change to the definition, it will be necessary to explain the former definitions of "new residential premises" and "commercial residential premises". These definitions are discussed under **Meaning of the term "residence"** below, but they are relevant here because sales of both "new residential premises" and "commercial residential premises" will be subject to GST if the other elements of s 9-5 of the GST Act are met. On the other hand, sales of "residential premises" that are neither "new residential premises" nor "commercial residential premises" will not.⁶ Sales made by unregistered entities would fall outside the scope of the GST altogether and will not be discussed in this article.

II SALES OF RESIDENTIAL PROPERTY

Sales of "residential premises" by registered entities will generally be input taxed⁷ – that is to say GST does not apply to the sale, and the seller is barred from claiming any input tax credits on acquisitions that relate to that sale.⁸ This rule does not apply where the residential premises are "new residential premises" or "commercial residential premises". Sales of "new residential premises" and "commercial residential premises" are generally subject to GST if the other elements of s 9-5 of the GST Act are present. The term "residential premises" was previously defined in s 195-1 of the GST Act as:
Land or a building that:

- (a) *is occupied as a residence; or*
- (b) *is intended to be occupied, and is capable of being occupied, as a residence; and includes a floating home.*

The former definition of "residential premises" is analysed at length under **Meaning of the term "residence"**, but for the sake of clarity, "new residential premises" are "residential premises" that have:

- (a) *not previously been sold as residential premises and have not previously been the subject of a long-term lease; or*
- (b) *been created through substantial renovations of a building; or*
- (c) *been built, or contain a building that has been built, to replace demolished premises on the same land.*⁹

The term "commercial residential premises" was defined to include:

- (a) *a hotel, motel, inn, hostel or boarding house; or*
- (b) *premises used to provide accommodation in connection with a school; or*

⁵ Explanatory Memorandum to *the Tax Laws Amendment (2006 Measures No. 3) Act 2006*

⁶ Sales of "residential premises" that are not "new residential premises" are input taxed supplies under s 40-65.

⁷ Section 40-65.

⁸ Section 11-15(2)(a).

⁹ Section 40-75.

- (c) *a ship that is mainly let out on hire in the ordinary course of a business of letting ships out on hire; or*
- (d) *a ship that is mainly used for entertainment or transport in the ordinary course of a business of providing ships for entertainment or transport; or*
- (da) *a marina at which one or more of the berths are occupied, or are to be occupied, by ships used as residences; or*
- (e) *a caravan park or a camping ground; or*
- (f) *anything similar to residential premises described in paragraphs (a) to (e).*¹⁰

It is unfortunate that Parliament chose the term “commercial residential premises” rather than a term that did not contain the words “residential premises”, since the potential for confusion is clear. The interrelationship between “residential premises” and “commercial residential premises” was discussed in the *Marana Holdings case*.¹¹

The appellants in that case attempted unsuccessfully to argue that “commercial residential premises” were merely a subset of “residential premises”. Their argument was that premises needed to be “residential premises” before they could be “commercial residential premises”.¹² Based simply on the language of the two terms, this argument is an appealing one. It is only when the relevant definitions are examined that the argument breaks down. The issue could perhaps have been more easily resolved if Parliament had instead used a term that did not contain the words “residential premises”.

III THE DEFINITION OF “RESIDENTIAL PREMISES”

Supplies of real property that meet the definition of “residential premises” will be input taxed supplies.¹³ Supplies of any other real property will not be input taxed, and if the other elements of s 9-5 are met, will be subject to GST. It is therefore vital that this definition be clear and unambiguous, but sadly just about every part of the definition harbours interpretational difficulties. Some of the more urgent issues include sales of vacant land, the meaning of the term “residence” and the distinction between “residential premises” and “commercial residential premises”.

A Sales of vacant land

A sale of vacant land potentially meets the definition of “residential premises” where the land is zoned for residential development. The definition refers to “land **or** a building”, so arguably *land* on its own or a *building* on its own could qualify. This is an argument dismissed outright by the Commissioner. He has made it clear that he does not consider vacant land as being capable of being occupied as a residence.

The definition requires that land must have a building affixed to it and that the building must have the physical characteristics that enable it to be occupied or be capable of occupation as a residence. Vacant land of itself can never have sufficient physical characteristics to mark it out as being able to be or intended to be occupied as a residence.¹⁴

The Commissioner’s view renders the wording of the definition somewhat troubling, since it is difficult to reconcile the construction of the definition that states “land ... that

¹⁰ Section 195-1.

¹¹ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068.

¹² *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068 at 5077.

¹³ Section 40-65.

¹⁴ Ruling GSTR 2000/20 at paragraph 25.

is ... intended to be occupied and is capable of being occupied as a residence ...” with the Commissioner’s statement that “... land of itself can never have sufficient physical characteristics to mark it out as being able to be or intended to be occupied as a residence”.

The Commissioner’s interpretation presumably relies on the premise that the ability to occupy land as a residence must be present at the time of purchase – a premise not explicitly supported by the wording of the definition. The trouble is that his interpretation makes nonsense of the use of the word “or” in the phrase “land *or* a building”. This is not an appealing approach, since an assumption that Parliament would put meaningless words into a statute is not lightly made – for example, in *Commonwealth v Baume*¹⁵ Griffith CJ referred with approval to comments made in *The King v Berchet*, a case decided in 1688, where the court said:

It was said to be a known rule in the interpretation of Statutes that such a sense is to be made upon the whole as that no clause, sentence, or word shall prove superfluous, void or insignificant, if by any other construction they may all be made useful and pertinent.¹⁶

So how do practitioners go about making all of the words of the definition useful and pertinent? While it may be accepted that vacant land cannot without more, be occupied as a residence, a suggested interpretation which would allow the phrase “land *or* a building” to be made “useful and pertinent” is that land be treated as meeting the definition of “residential premises” if it is intended to be occupied as a residence and is capable (at some stage) of being occupied as a residence. In other words, vacant land should be treated as residential premises provided the land has the attributes necessary to enable a dwelling to be built upon it, such as appropriate zoning, local Council consents and so on.

This problem arose primarily because the original definition of “residential premises” did not include a requirement that the premises be capable of being occupied as a residence. In its original form, the definition read “land or a building occupied or intended to be occupied as a residence, and includes a floating home”. In this form, the definition made perfect sense, and allowed for land that was *intended to be occupied as a residence* to meet the requirements of the definition. The later addition of the words that the premises be *capable of being occupied as a residence* is what has created the confusion.¹⁷

The Explanatory Memorandum to this amendment suggested that this additional requirement was inserted to ensure that sales of vacant residential land will not be input taxed under s 40-65 unless it was permissible to use the land for residential purposes and the land had some facilities ordinarily associated with residences (ie water and sewerage).¹⁸ This suggests that land with the necessary plumbing would be capable of being occupied as a residence and so should be treated as “residential premises”.

This interpretation is later implicitly contradicted where the Explanatory Memorandum states that:

The amendment ensures that sales of vacant residential land will not be input taxed under section 40-65. The supply of land is not input taxed where it is:

- vacant residential land;
- commercial land; or

¹⁵ *Commonwealth v Baume* (1905) 2 CLR 405.

¹⁶ *Commonwealth v Baume* (1905) 2 CLR 405 at 414.

¹⁷ Substituted by No 176 of 1999, s 3 and Sch 1 item 157, effective 1 July 2000.

¹⁸ Explanatory Memorandum to *A New Tax System (Indirect Tax and Consequential Amendments) Act 1999* paragraph 1.167.

- new residential premises.¹⁹

This wording suggests that supplies of vacant residential land will not be input taxed even if the land had *those facilities ordinarily associated with residences*.

In any event, it is doubtful whether the amended definition met this stated objective because it still suggested that land on its own could qualify as “residential premises”. As pointed out above, it is difficult to reconcile the part of the definition which states that “residential premises means land ... that ... is ... capable of being occupied as a residence” with the stated policy intent behind the amendment, namely that sales of vacant residential land will not be input taxed under s 40-65.

If, as the Explanatory Memorandum suggests, the intention was to disqualify vacant land from meeting the definition of “residential premises”, a more effective way to have done it might have been to replace the phrase “land or a building” with the phrase “land and a building, or a building on its own”. It is suggested that wording the definition in this way would have meant that land by itself would not meet the requirements to be “residential premises”. On the current wording, it is entirely possible that land on its own could meet the definition of “residential premises” despite the stated intention in the Explanatory Memorandum.

Vacant land sold to a purchaser who bought it for the future construction of a residence (or several residences) would arguably meet the requirement of being capable of being occupied as a residence unless the phrase “capable of being occupied” meant at the time of sale. It was open to Parliament to have added the words “at the time of sale” after the words “capable of being occupied as a residence”, which would have precluded this interpretation, but it did not. Accordingly, applying the rule outlined in *The King v Berchet*,²⁰ one way to make all the words of the definition “useful and pertinent” would be to allow for the requirement (of being capable of being occupied as a residence) to be met at a time later than the time of sale.

A possible scenario that would allow the definition to make sense in its current form is where a person built a residence on land owned by someone else. If that land was subsequently sold to the owner of the residence, the land would then meet the definition of “residential premises”, since it would be capable of occupation as a residence at the time of sale. It is suggested that this situation is rare, and probably not one contemplated by the drafters of the legislation at least insofar as the Explanatory Memorandum sets out the drafters’ understanding of the scope of the law.

B Meaning of the term “residence”

The term “residence” is an essential feature of the definition “residential premises”. To be residential premises, the premises must be occupied as a residence or be capable of being occupied as a residence. Given the importance of this term, it is curious that Parliament chose not to define it. Since the term is not defined, it must take its ordinary meaning.

In common with other words in statutes that are meant to “take their ordinary meaning”, the meaning of the term “residence” and the phrase “... occupied as a residence ...” have both proved difficult to interpret. This is particularly true in relation to the treatment of strata-titled units offering short-term accommodation as so-called “serviced apartments”. The issue came to prominence recently in the *Marana Holdings*

¹⁹ Explanatory Memorandum to *A New Tax System (Indirect Tax and Consequential Amendments) Act 1999* paragraph 1.168.

²⁰ Referred to in *Commonwealth v Baume* (1905) 2 CLR 405.

case²¹ where the court was asked to decide whether the sale of a converted motel unit was input taxed under s 40-65 as a supply of “residential premises”. The case involved the purchase of motel units by a developer who intended to convert them into strata-titled units and sell them as apartments to private buyers. Following the sale of one of the units, which had been converted from a motel room with an adjoining car space, Marana Holdings sought declaratory orders that the sale was input taxed.

Since it was agreed by the parties that the conversions of the motel units into apartments did not amount to “substantial renovations”,²² the central issue in the case was whether the motel units were “residential premises” when they were purchased in the first instance by the developer. Had that been the case, any subsequent sale of the units after they had been converted into strata-titled units would have been input taxed under s 40-65 as a sale of “residential premises” that were not “new residential premises”.

Resolution of the issue turned on the definition of “new residential premises”. The term “new residential premises” is defined, among other things, as premises that have not previously been *sold* as residential premises.²³ If the motel units had been “residential premises” as defined when the developers acquired them, that sale would have counted as a previous sale of residential premises. Any subsequent sale of the units by the developer could not then have been a supply of “new residential premises” because they would previously have been sold as residential premises.

In concluding that the motel units were not “residential premises” when they were first sold to the developers, the court considered that the word “residence” as it appears in the definition of “residential premises” required a degree of permanence or continuity of occupation – a quality not ordinarily present in motel units.

Central to this argument was the notion that for accommodation to be “residential premises”, it needed to be “**occupied** as a residence”, which, the court concluded, meant that there needed to be an element of long-term occupation. The court referred with approval to the comments of Mr Lightman in *Urdd Gobaith Cymru v Commissioner of Customs and Excise*.²⁴

I agree that “a residence” clearly implies a building with a significant degree of permanence of occupation. However the word loses that clear meaning when used as an adjective. In ordinary English “residential accommodation” merely signifies lodging, sleeping or overnight accommodation. It does not suggest the need for such accommodation to be for any fixed or minimum period.²⁵

Adopting this approach, it was the court’s view that to “occupy” a place as a residence required more than merely occupying rooms as motel guests. Accordingly, the motel units were not “residential premises” when they were sold to the developer. Thus, when the developer sold the converted strata-titled units to the public as “residential premises”, it was a first sale of residential premises so the units were “new residential premises”. Accordingly, the court found that the sale was subject to GST as a taxable supply.

The developers appealed the decision, but were unsuccessful.²⁶ In the decision handed down by the Full Federal Court, the terms “residence” and “reside” were exhaustively

²¹ *Marana Holdings Pty Ltd v Commissioner of Taxation* 2004 ATC 4256.

²² Had the conversions amounted to “substantial renovations”, the units thus created would have been treated as new residential premises under s 40-75(1)(b) anyway.

²³ Section 40-75(1)(a).

²⁴ *Urdd Gobaith Cymru v Commissioner of Customs and Excise* [1997] V & DR 273.

²⁵ *Urdd Gobaith Cymru v Commissioner of Customs and Excise* [1997] V & DR 273 at 279.

²⁶ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068.

examined, with reference to the dictionary definitions of those terms in the *Macquarie Dictionary*²⁷, the *Oxford English Dictionary*²⁸ and the *Shorter Oxford Dictionary*.²⁹ Common to all the dictionary definitions was the suggestion that to constitute a “residence”, the premises needed to have an element of permanent or long-term occupation. Clearly, both “reside” and “residence” have the connotation of permanent, or at least long-term commitment to dwelling in a particular place.³⁰

Support for this interpretation is to be found in the Explanatory Memorandum that accompanied the legislation. Explaining the reason for treating a supply of residential premises as input taxed, page 15 of the executive summary stated that this was done to ensure comparable treatment for renters with owner-occupiers. On this analysis, the Full Federal Court found that:

The references to “residential rents” and “owner-occupiers” suggest the intention that a person renting a house (including a home unit) be put on the same footing as a person who owns his or her own home — neither is to pay GST in connection with such occupation. Similarly, the reference to the supply of a new “house” would not normally include an hotel or motel, suggesting that the expression “residential premises” is not intended to do so.³¹

So while it may be accepted that “residential premises” unlike “commercial residential premises” require a degree of permanence and continuity, the implication of this decision went well beyond the case itself and carried implications for all styles of accommodation that cater for short-term occupancy.

The Commissioner has been at pains to point out that a lease of residential units to managing agents was an input taxed supply, so purchases of apartment developments were not creditable acquisitions. The reasoning of the Commissioner was that these units were “residential premises” and not “commercial residential premises”, and they only became “commercial residential premises when aggregated with others and operated as a whole by the managing agents.

As explained above, a supply of both “new residential premises” and “commercial residential premises” would carry GST in the price, so the characterization of these units would determine whether the purchasers would be entitled to input tax credits on the acquisition. If the units were “commercial residential premises”, then the purchasers would be entitled to input tax credits as long as they were purchasing the units to carry on an enterprise. On the other hand, if the units were “residential premises”, purchasers would be denied input tax credits under s 11-15(2)(a).³²

The Commissioner’s view was that the apartments were “residential premises” at the time of purchase and would retain their character as “residential premises” if and when they were later sold or leased.³³ An individual unit, so the argument goes, could only take on the character of “commercial residential premises” when aggregated with others and operated in the same manner as a hotel, motel, inn or hostel. A graphic illustration of a typical investor/manager arrangement is shown below.³⁴

²⁷ Fourth Edition 2005

²⁸ Second Edition 1989

²⁹ Fifth Edition 2002

³⁰ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068 at 5073.

³¹ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068 at 5074.

³² Paragraph 11-15(2)(a) states that you do not acquire a thing for a *creditable purpose* to the extent that you acquire it in making supplies that would be input taxed.

³³ Ruling GSTR 2000/20 paragraph 51–54.

³⁴ Taken from Ruling GSTR 2000/20.



Based on the Commissioner’s view, the letting of the apartment to the manager would be an input taxed supply under s 40-35 since investors would be leasing “residential premises”. The unit owners accordingly would not account for GST on the supply and would be unable to claim input tax credits either for the cost of acquiring their units or for the ongoing costs of ownership.

As things stood before the *Marana Holdings* decision, Treasury was reaping the benefit of GST paid by the developers of these apartment complexes. As explained, sales of these apartments were subject to GST because they are “new residential premises”, so 1/11th of the price (or margin in the case of developers using the margin scheme³⁵) was being paid on every sale. By treating the apartments as “residential premises” even GST-registered purchasers were unable to claim input tax credits for the GST included in the price.

If under the *Marana Holdings* decision strata-titled units such as serviced apartments that provided short-term accommodation would no longer be treated as “residential premises”, the leasing of these units to managing agents would potentially become subject to GST if the other elements of s 9-5 were present and (more importantly) the owners would be entitled to input tax credits on the purchase of those units, provided they were registered for GST at the time of acquisition and acquired the units in carrying on an enterprise. The revenue costs of refunding these input tax credits to the large number of owners renting their units in this way would have been significant.

Soon after the Full Federal Court handed down its decision in *Marana Holdings*, the Minister for Revenue and Assistant Treasurer, Hon Peter Dutton, announced that the GST Act would be amended, (allegedly) to remove uncertainty in relation to the treatment of certain types of real property.³⁶ In reality, the move probably had more to do with protecting the revenue from a potentially disastrous landslide of input tax credit claims based on the *Marana Holdings* decision than any desire to remove uncertainty from the definition.

On 10 April 2006, Treasury released an Exposure Draft³⁷ of legislation to amend the definition of “residential premises”. The amendments are to apply retrospectively from 1 July 2000. At the core of the amendment is the addition of the words “regardless of the term of occupation” after the words “residential accommodation” in ss 40-35(2)(a), 40-65(1), 40-65(2)(b), 40-70(1)(a) and 40-70(2)(b). References to “premises to be used predominantly for residential accommodation” are now read as “premises to be used predominantly for residential accommodation irrespective of the term of occupation”.

In an apparent move to prevent the amendments from applying to establishments such as hotels, motels, boarding houses or inns, s 40-75(1)(a) was amended by the addition of the words “other than commercial residential premises” after the words “residential premises”. The provision now defines “new residential premises” as “residential premises that have not previously been sold as residential premises, *other than commercial residential premises*, and have not previously been the subject of a long-term lease”.

The definition of “floating home” in s 195-1 has also been amended by the proposed

³⁵ Section 75-5.

³⁶ Minister for Revenue and Assistant Treasurer Press Release No 006, 27 February 2006.

³⁷ Exposure Draft on the GST Treatment of Residential Premises, released 10 April 2006.

addition of the words “regardless of the term of occupation” after the term “occupied”. The definition now defines a floating home as “... a structure that is composed of a floating platform and a building designed to be occupied (*regardless of the term of occupation*) as a residence that is permanently affixed to the platform, but does not include any structure that has means of, or is capable of being readily adapted for, self-propulsion”. This was presumably done to ensure that floating homes would not be classified as “commercial residential premises” either.

Finally, the definition of the term “residential premises” was replaced altogether. The new provision defines “residential premises” as:

land or a building that:

- (a) *is occupied as a residence or for residential accommodation; or*
- (b) *is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation; (regardless of the term of the occupation or intended occupation)*

and includes a floating home.

The Explanatory Memorandum cites potential difficulties in distinguishing between supplies of premises that are “residential premises” from supplies of premises that do not constitute “residential premises” as the prime reason for the amendment. In particular, Treasury was concerned that the court’s reasoning was likely to lead taxpayers to treat certain supplies of real property as taxable rather than input taxed, specifically:

- letting of strata-titled units such as serviced apartments by owners to guests on a short term basis;
- leasing of strata-titled units to hotel operators or similar operators; and
- leasing of display homes and provision of certain short-term employee accommodation.³⁸

The intention behind the amendments would be to ensure that these supplies would all be input taxed supplies under s 40-35.

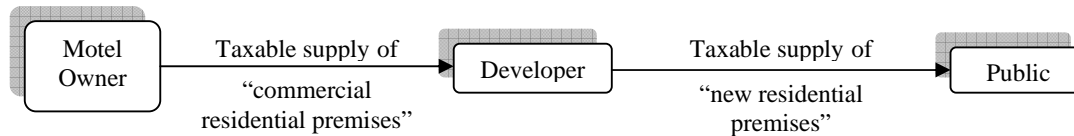
Would the amendments make a difference to cases like *Marana Holdings*? It is suggested not – at least not in relation to the outcome. If the *Marana Holdings* case was decided in the context of the new amendments, the outcome would be the same but the reasoning might differ. The *Marana Holdings* decision essentially said that motel units could not be “residential premises” because they were not occupied for long enough. Under the proposed amendments, motel units might be “residential premises” because the length of stay would no longer be relevant.

So even though the motel units might be “residential premises”, a developer who bought them to convert and sell as strata-titled units would still not be required to treat the sale as an input taxed supply. This is because under the proposed new definition the units would remain “new residential premises” despite their earlier sale as “residential premises”. The proposed new definition states that premises are “new residential premises” if they have not previously been sold as residential premises *other than as commercial residential premises*. This would effectively mean that the earlier sale of the units (even as residential premises) would not count.

Thus under these changes, the sale of the converted strata-titled units by the developer would be treated as the first sale of residential premises. This would mean that the converted strata-titled units would be “new residential premises” because they would not be treated as having previously been sold as residential premises. Therefore, the

³⁸ Goods and Services Tax Treatment of Residential Premises Explanatory Material paragraph 1.3.

sale would be a taxable supply and the developer would need to account for GST on the sale. The sequence of transactions is explained in the diagram below.



Accordingly, the sale from the developer to the public would remain a taxable supply, so the amendments would achieve their aim of preserving the result in the *Marana Holdings* decision.

C The distinction between “residential premises” and “commercial residential premises”

The distinction between “residential premises” and “commercial residential premises” is an important one since a supply of “commercial residential premises” by way of sale or rent is potentially a taxable supply, whereas the supply of “residential premises” by way of sale or rent is an input taxed supply (unless it is a sale of “new residential premises”). The distinction is also important in the proposed definition of “new residential premises” because a sale of residential premises would not be counted as a sale if they were sold as “commercial residential premises”. Accordingly, a subsequent sale of those premises would be treated as the first sale, so they would be considered “new residential premises” despite the earlier sale.

So how does one distinguish between “residential premises” and “commercial residential premises”? As suggested above, the language implicitly supports the argument that premises cannot be “commercial residential premises” unless they are themselves “residential premises” – in other words “commercial residential premises” are merely a subset of “residential premises”. Unfortunate use of language aside, the definitions of the two terms have nothing in common.

“Residential premises” is supposed to refer to dwellings while “commercial residential premises” is supposed to refer to commercial establishments. The main problem with the definition of “commercial residential premises” is paragraph (f). The inclusion of the words “anything similar” in the paragraph is an example of perhaps one of the most annoying practices of legislative draftspersons. It is sometimes referred to as the “just in case” strategy and occurs frequently in legal definitions. Something is defined by including those things that the drafter considers necessary, but just in case there may be something he or she has not thought about, they include “anything similar” just in case. Unfortunately, the use of this strategy broadens the scope of the definition so much as to render it virtually useless. Because of this inclusion, one could conceivably have premises that are both “residential premises” as defined and “commercial residential premises” as defined. This is a highly unsatisfactory outcome because if premises are both residential premises and commercial residential premises, which takes precedence? This difficulty was acknowledged by the Full Federal Court in the *Marana Holdings* appeal.³⁹

Clearly, [paragraph (f)] is intended to extend the definition beyond the premises identified in pars (a) to (e). The problem lies in identifying the features which will

³⁹ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068 at 5075.

lead to particular premises, not otherwise within the definition, being so included. Given the difficulties with pars (c) and (d) to which we have referred, and the apparent exclusion of accommodation in some educational establishments which accommodation might conceivably be residential premises, we doubt whether it was intended that all premises within the definition of “commercial residential premises” also be “residential premises” as defined. Of course that does not exclude the possibility of some overlap. Premises used as a private residence might also be used to provide accommodation to paying guests. Whether such premises are described as an “hotel” a “motel” or a “boarding house” may depend upon many factors, including size of the premises, proportions used for private and rental accommodation, liquor licensing requirements, arrangements for meals and other services and questions of public relations.⁴⁰

The Commissioner has attempted to differentiate “commercial residential premises” from “residential premises” in GST Ruling GSTR 2000/20. At paragraph 83 he outlined a number of factors he considers relevant in determining whether premises were “similar” to residential premises described in paragraph (a) of the definition of “commercial residential premises”. Since the premises described in paragraphs (b) to (e) of the definition would not ordinarily be seen as “residential premises” as that term appears in paragraph (f) of the definition, he confined his analysis to paragraph (a).

The relevant factors are:

- commercial intention;
- multiple occupancy;
- holding out to the public;
- accommodation is the main purpose;
- central management;
- management offers accommodation in its own right;
- services offered; and
- status of guests.⁴¹

It should be noted that these factors are the characteristics commonly used to identify establishments such as hotels, motels, inns, hostels or boarding houses; so arguably, premises exhibiting some or most of these characteristics should qualify as “anything similar to residential premises described in paragraph (a)”.

An exhaustive analysis of each of these factors is beyond the scope of this article, but it may be useful to examine one of the more contentious of them - namely the issue of multiple occupancy - since the Commissioner relies on this factor more than any of the others to deny input tax credit claims to purchasers of strata-titled units.⁴²

The Commissioner believes that it is only when strata-titled units are aggregated with others under a management arrangement that they take on the characteristics of “commercial residential premises”. Based on this view, a strata-titled unit operated by an individual investor alone would not be considered “commercial residential premises” even if its sole purpose was to provide short-term accommodation to the public and all the other factors outlined above were met.

It is suggested that this is a specious argument because it ignores the fact that what is required to satisfy the terms of paragraph (f) of the definition is that the premises be “similar” to residential premises described in paragraph (a). The *Macquarie Dictionary* defines the term “similar” as “having likeness or resemblance, especially in a general way”. To suggest that all of the factors outlined above (in particular the multiple

⁴⁰ *Marana Holdings v Commissioner of Taxation* 2004 ATC 5068 at 5078.

⁴¹ GST Ruling GSTR 2000/20 at paragraph 83.

⁴² GST Ruling GSTR 2000/20 at paragraph 52.

occupancy factor) must be present before premises have the likeness or resemblance of hotels, motels, inns, hostels or boarding houses, especially in a general way, is an argument that cannot be sustained. Premises that possess all of these characteristics would be *identical* rather than *similar* to hotels, motels, inns, hostels or boarding houses, and the paragraph only requires that they be *similar*.

In addition, it should be pointed out that GST Rulings are neither binding on the Commissioner nor on taxpayers. This is because, unlike Taxation Rulings, they are not covered by either Division 358 or 359 of Schedule 1 to the *Tax Administration Act* 1953. As such, they do no more than explain how the Commissioner interprets the legislation. Accordingly, until the issue is clarified, either through amending legislation or judicial interpretation, it remains open to purchasers of strata-titled units to challenge the Commissioner's interpretation of what is meant by "anything similar to residential premises described in paragraphs (a) to (e)". Again, the amendments to the definition of "residential premises" would do nothing to address this issue nor to resolve the position for investors. Certainly, investors who purchase strata-titled units to let on a commercial basis would be no less likely to succeed in claiming input tax credits than they would have been without the amendments.

D Premises intended to be occupied as a residence

Another difficulty with the definition of "residential premises" is the use of the phrase "intended to be occupied as a residence". At first blush, this would appear to refer to the intention of the purchaser, an interpretation implicitly supported by the Supreme Court in *Toyama Pty Ltd v Landmark Building Developments Pty Ltd*.⁴³ The court was examining the meaning of the phrase "to be used predominantly for residential accommodation" in s 40-35(2)(a) and s 40-65(1).

The construction of both provisions should be approached in the same way. They require a prediction as to the future use of the premises. The most important factor in such a prediction is the intention of the future owner or lessee of the property. In the case of a lease, the question of how the property is to be used in the future will usually be determined by the terms of the lease. In the case of a sale, the likely future use of the property will probably depend on the purchaser's intentions, to be assessed having regard to objective circumstances such as the physical condition of the premises, the zoning or any restrictive covenants.⁴⁴

It should be noted that the court was reluctant to apply this reasoning directly to the phrase "... intended to be occupied as a residence ..." in the definition of "residential premises". This reluctance was apparently influenced by the comments of the Full Federal Court in the *Marana Holdings* appeal. The Full Federal Court said:

The appellants' [purchasers'] argument assumes that the relevant intention is that of the appellants [purchasers] at the time of acquisition. We disagree. If Parliament intended that a subjective intention be the relevant consideration for the purposes of s 40-75(1)(a), one might reasonably have expected it to have indicated whose intention was relevant for that purpose — the vendor's or the purchaser's. In any event, it is difficult to see why such intention would be of any significance in this context.

In our view the word "intended" in the definition is used in a different sense. The relevant meaning of the verb "intend" is, according to Shorter Oxford, "[h]ave as one's purpose (an action etc)". The verb may also be used in the passive form to describe the object of an intention. In the present case, the passive verbal form "is intended" has as its grammatical subject the connective "that", standing in place of the

⁴³ *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83.

⁴⁴ *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83 at [92].

words “land or a building”. The person having the relevant intention is not identified. This sentence structure is commonly used to describe characteristics of the subject of the sentence, which subject is the object of the relevant intention. To say that a building is “intended” to be occupied as a residence implicitly describes the intention with which it was designed, built or modified, which intention will be reflected, to greater or lesser extent, in its suitability for that purpose.⁴⁵

It is curious that while the court in the *Toyama* case was reluctant to accept the proposition that the subjective intention of the purchaser did not apply in the case of the definition of “residential premises”, it was prepared to apply the subjective test in determining whether the premises were to be used predominantly for residential accommodation. It is respectfully suggested that this is an inconsistent approach. One cannot on the one hand say that the subjective intention of the purchaser is not to be taken into account in determining whether the premises are “intended to be used as a residence” while on the other hand saying that the subjective intention of the purchaser is the determining factor in deciding whether premises are to be used “predominantly for residential accommodation”.

While accepting that a distinction may be valid given the different wording of the two provisions, it is suggested that if the subjective intention of the purchaser was relevant at all in determining the status of the premises, that intention should be relevant in both contexts.

On the other hand, if the legislative intent was to enable parties to determine the status of the premises without reference to the subjective intention of either party (a preferred outcome), that subjective intention should have been excluded from both the definition of “residential premises” and the construction of ss 40-35(2)(a) and 40-65(1). Had this been done, it would have eliminated the need for complex covenants in leases and sales of residential property. These covenants are essential to protect the seller in the event that the nature of the supply is afterwards affected by the subjective intention of the purchaser – an intention that might remain unknown to the seller until after the transaction has been settled.

This issue remains a major difficulty for GST-registered lessors or sellers of residential property. If a property is let or sold and later employed for a purpose other than residential accommodation, the lease or sale would potentially change from an input taxed supply to a taxable supply. This is an entirely unsatisfactory outcome, since s 9-40 makes it clear that the “supplier” is responsible for paying the GST. Without an enforceable covenant, the lessor or seller would be disadvantaged by having to remit 1/11th of the rent or the purchase price to the ATO simply because the tenant or purchaser decided to use the property for a purpose other than residential premises – an event over which he or she might have had no control. A further difficulty is that the lessee or purchaser would be quite within their rights to demand a tax invoice to support a claim for an input tax credit – a windfall brought about by their own actions.

The intention of the purchaser is also relevant in situations involving a sale of land with a vacant house on it. If the purchaser had no intention of living in the house, preferring instead to demolish the house and replace it with another, his or her subjective intention might render the sale subject to GST. If the subjective intention of the purchaser was considered, the supply of the property could not be input taxed because on this analysis, the purchaser did not intend to use the property “predominantly for residential accommodation”. As discussed, if we accept that land by itself cannot meet the requirement of being a residence, then the land and vacant house can also not meet the definition of “residential premises”. If the other requirements of s

⁴⁵ *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) 214 ALR 190 at 203–204.

9-5 were present, the sale would be a taxable supply.

This issue arose in the *Toyama* case,⁴⁶ which involved an application for equitable compensation for an alleged breach of trust, and arose out of the sale of a piece of real estate. The applicant, Landmark Building Development Pty Limited (Landmark), and the plaintiff in the proceedings, Toyama Pty Limited (Toyama), were the co-owners of the real estate. Landmark owned two-thirds of the land as tenant in common with Toyama, which owned one-third.

The property was sold by auction on 7 August 2003 for \$2,760,000. The contract for sale provided that the sale was a taxable supply under s 9-5 of the GST Act. A house had been built on the land that comprised two residences.

The land was marketed as a development site, since the Port Stephens Council had given approval for the erection of a 14-unit development on the land. The trustees expected, as turned out to be the case, that the land would be purchased by a developer, the house demolished, and new units built on the site.

Landmark's view was that the sale was not a taxable supply because, among other things, the supply was an input taxed supply of residential premises. Its contention was that the trustees acted in breach of trust and were therefore liable to compensate Landmark for two-thirds of the loss occasioned by that breach.

In dismissing the appeal, the court found that the trustees were correct in describing the sale as a taxable supply. The purchaser, Concrete Pty Ltd, intended to demolish the existing buildings. The fact that the existing buildings were constructed as a residence (which made them "residential premises") did not sway that court. It was variously suggested in the evidence that the house was used as a residence by the directors, leased to tenants as a residence and also used as a veterinary clinic. What was not in dispute however was that the building (although not currently used as a residence) was built as a residence and was capable of being occupied as a residence. What was also not in dispute was that the purchasers intended to erect residential units on the land.

In concluding that the property was not "residential premises", the court focused on the intention of the purchasers – that was, to demolish the existing house and erect 14 residential units on the property. Notwithstanding that the 14 residential units could only have been occupied as residences, the court focused on the building on the property at the time of sale.

Landmark did not submit that the purchaser's intention that the new units to be constructed on the land be used as residential accommodation satisfied s 40-65(1). They are not the residential premises sold.⁴⁷

With respect, this misses the point. The residential premises sold was the "land **or** a building" not just the building. Since the land was purchased for the explicit purpose of erecting residential dwellings, it is suggested that this was precisely the "residential premises" sold. Moreover, had Parliament made it clear what was meant by the phrase "intended to be occupied as a residence", the confusion would not have arisen.

E Premises capable of being occupied as a residence

Premises not occupied as a residence at the time of sale may still meet the definition of "residential premises" if they are "intended to be occupied and *capable of being occupied as a residence*."

As pointed out, the original definition of "residential premises" did not include a

⁴⁶ *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83.

⁴⁷ *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83 at paragraph 103.

requirement that the premises be capable of being occupied as a residence.

The Commissioner's approach follows the policy intent outlined in the Explanatory Memorandum, in that he takes the phrase "capable of being occupied as a residence" to mean that the premises must possess the requirements necessary to occupy it as a residence **at the time of sale**.⁴⁸ As discussed, this is not explicitly stated in the legislation and makes a sensible interpretation of the definition of "residential premises" virtually impossible.

The Commissioner considers that for premises to have the requirements necessary to occupy it as a residence, it must provide the occupants with sleeping accommodation and at least some basic facilities for day-to-day living – these include such things as areas for sleeping, eating and bathing, but it is not necessary that these things be arranged in a similar manner to a conventional house or apartment.⁴⁹ The Commissioner believes that a residence may consist of detached buildings, semi-detached buildings, strata title apartments, single rooms or suites of rooms within larger premises. While it is difficult to see how a single room would possess the required characteristics, it is encouraging to note that the Commissioner has not dictated the style of the accommodation required and he allows for the possibility that dormitory or barrack-style accommodation could still meet the concept of a residence.

An issue that arises in the context is one of homes that have been removed from the land upon which they were originally situated and taken to a display area for sale. These homes may have their fittings intact, and the seller would usually offer a relocation and stumping service as part of the price, so purchasers would receive a completed house permanently affixed to land of their choice. These homes are popular with first home buyers since they may carry a lower per-square-metre cost than that applicable to newly built homes. The obvious question is whether the sale of these homes would be input taxed as a supply of "residential premises" or taxable as a supply of something else.

The practice in the industry is to treat these sales as taxable supplies, but it is suggested that this is the result of erring on the side of caution rather than any coherent analysis of the definition of "residential premises". The houses are not occupied as a residence when they are sold, so to be an input taxed supply under s 40-65 the premises must be intended to be occupied as a residence and capable of being occupied as a residence. In the majority (if not all) of the cases, the premises would be purchased as homes, so the question to be answered is whether the premises are capable of being occupied as residences. And it is the Commissioner's view that the premises should be capable of being occupied as a residence at the time of purchase.

The extent to which a structure is capable of being occupied as a residence will, according to the Commissioner, depend upon whether the structure possesses "sleeping accommodation and at least some basic facilities for day to day living". These basic facilities are said to include areas for sleeping, eating and bathing – one might even add areas for food preparation and laundry. Whether these facilities exist in a structure would be a matter of fact, and it would be tempting to dismiss this as a purely objective exercise. One cannot however ignore the subjective element – things that are basic facilities to one person may be woefully inadequate to another. It is at least arguable that these houses, once removed from their original location and stored in a display village, would still possess sufficient basic facilities to satisfy many people.

This would lead to the absurd notion that where a purchaser fell into the less

⁴⁸ Ruling GSTR 2000/20 at paragraph 25.

⁴⁹ Ruling GSTR 2000/20 at paragraph 26.

discerning category of people who considered that the house offered adequate basic facilities, the sale should be treated as input taxed, since the structure was “residential premises” as far as they were concerned (being intended to be occupied and capable of being occupied as a residence). On the other hand a sale to the more discerning buyer should be treated as taxable, since they would not consider the facilities adequate, and therefore not capable of being occupied as a residence. This demonstrates the unsatisfactory nature of wording in legislation that requires subjective analysis.

IV CONCLUSION

The title of this article asks whether the amendments to the definition of “residential premises” go far enough. For the reasons outlined in the article, it is suggested not. That is not to say that attempts to clarify the definition should be dismissed merely because not all the potential problems have been ironed out – far from it. There are many other provisions in this legislation that are equally fraught with problems, and equally deserving of the legislature’s attention, so an attempt to fix them all would be a monumental task.

These suggestions are modestly offered so that there is at least an attempt to remove uncertainty from what is the very risky business of property development.

The first suggestion involves the phrase “land or a building” in the definition. The policy intent of Parliament as suggested by the Explanatory Memorandum⁵⁰ was to preclude vacant residential land from meeting the requirements of the definition of “residential premises”. The wording of the definition suggests that Parliament still wanted a building on its own to be able to meet the definition. These two intentions could perhaps be made clearer if the phrase “land or a building” was reworded as “land and a building; or a building on its own ...”. Moreover, if the only reason for the addition of the words “capable of being occupied as a residence” was to preclude supplies of vacant residential land, commercial land or new residential premises being input taxed, those words could be removed and thus solve many of the other anomalies in the definition.

Another suggestion involves the potential difficulty in distinguishing between “residential accommodation” and “commercial residential accommodation”. The difficulty is entirely due to the inclusion of paragraph (f) in the definition of “commercial residential premises”. The inclusion of phrases such as “anything similar” is all too common in tax legislation, particularly in definitions. Rather than allowing a single unforeseen item to escape the definition, people who draft legislation rely on these catch-all provisions that can do more harm than good.

It is suggested that paragraph (f) of the definition of “commercial residential premises” be repealed in the interests of achieving greater clarity. If this results in some premises escaping classification as “commercial residential premises”, the provision could always be amended to include it later.

The use of the phrase “intended to be occupied as a residence” is the subject of some interpretational difficulty. Whenever a provision requires an examination of *intention*, it leads to the inevitable difficulty of deciding whether it refers to the subjective intention of a party (which is notoriously difficult to prove) or some objective intention that can be determined by reference to the surrounding facts. So it is with the interaction between the definition of “residential premises” in s 195-1 on the one hand, and the provisions of s 40-35(2)(a) and s 40-65(1) on the other. Both require a determination as

⁵⁰ Goods and Services Tax Treatment of Residential Premises Explanatory Material paragraph 1.3.

to whether premises are intended to be occupied as a residence, but that intention is said to be objective in the case of the definition, but subjective in the case of the two provisions.

The obvious problem with this construction is that entities may be made liable for GST through events entirely outside their control. Someone who purchases a residence and later uses it for a commercial purpose will have nothing to lose from this conduct, since the liability to pay the GST rests with the seller. Unless the seller had the foresight to insert the appropriate covenants, he or she would incur an unforeseen liability to remit 1/11th of the purchase price as GST, while the purchaser (whose conduct brought it about) would effectively enjoy a windfall of 1/11th of what he or she paid to acquire the property.

This situation might be corrected by ensuring that the intention implied by s 40-35(2)(a) and s 40-65(1) was an objective one. If for some reason it was necessary to have the intention surrounding the supply to be a subjective one (and one can scarcely imagine why), then it would be fairer for the intention of the seller to be the deciding factor. This is because, as discussed, it is the seller who bears the risk of GST being payable on the transaction.

The subjective/objective assessment again presents a problem with the part of the definition that reads “capable of being occupied as a residence”. What one person might consider “capable of being occupied as a residence” might be spurned by another. It is suggested that the Commissioner’s attempt to inject some objectivity into what can be regarded as capable of being occupied as a residence has not entirely removed this uncertainty.

The Explanatory Memorandum⁵¹ suggests that the reason for the addition of this phrase was to make it clear that supplies of vacant residential land, commercial land or new residential premises would not be input taxed. It is suggested that this objective might be more effectively achieved by substituting the words “land and a building; or a building on its own” for the words “land or a building” in the definition. If this was done, the words “capable of being occupied as a residence” could be removed altogether.

⁵¹ Goods and Services Tax Treatment of Residential Premises Explanatory Material paragraph 1.3.