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FOREWORD

The addresses and articles included in this edition of the *Journal of the Australasian Tax Teachers Association (JATTA)* are based on presentations made at the 20th Annual Conference of the Australasian Tax Teachers Association (ATTA) held on 23rd – 25th January 2008 at The University of Tasmania, Hobart. It was the first time in the 20 year history of ATTA that the conference had been held in Tasmania.

The opening day of the conference featured a PhD workshop and papers presented by students, followed by a welcome address by the Chancellor of the University of Tasmania, Mr Damian Bugg, AM QC. The Patron's Opening Plenary address introduced the afternoon's teaching workshop sessions.

His Excellency, the Honourable William Cox AC RFD Ed, Governor of Tasmania officially opened the 20th Annual ATTA conference on the morning of day 2. The thoughtful insights provided by the Governor during his opening address and indeed on his understandings of the current issues in taxation were appreciated by all. Later that evening His Excellency hosted a reception for delegates at Government House.

Following the official opening of the conference, Mr Michael D'Ascenzo, Commissioner of Taxation, addressed delegates. Professor Cliff Fleming from Brigham Young University, Provo, Utah, USA, opened the afternoon's proceedings on day 2. The Commissioner's address together with Professor Fleming's paper and the plenary address delivered the following morning by The Honourable Mr Justice Richard Edmonds, Federal Court of Australia, are all featured in this issue.

The highlights of the conference continued throughout day 3, with the final plenary session being presented by Professor Pasquale Pistone, from the Vienna University of Economics and Business Administration. This presentation was based on Professor Pistone's current award winning research involving a 5-year project on '*The Impact of European law on the relations with third countries in the field of direct taxes*'.

A further feature of this year's conference was the depth and quality of the 70 papers presented in the parallel sessions, culminating in the publication of this edition of peer reviewed papers. The general conference theme "Tax: The Devil's in the Detail", used a common idiom to encapsulate something of Tasmania's uniqueness, the Tasmanian Devil (*Sarcophilus harrisii*), and the uniqueness and challenges that stimulate intellectual debate and writings in tax. The papers in this issue provide a significant contribution to the literature, specifically through a variety of thought provoking perspectives on the important 'detail' synonymous with tax.

Finally, the efforts of many contributed enormously to the outstanding success of the 20th Annual Conference and the publication of this edition of peer reviewed papers. Sincere thanks to all those involved, particularly the authors and the anonymous referees for their continued support of ATTA.

Bernadette Smith (University of Tasmania, Australia)

19 December 2008

KEYNOTE ADDRESS

RECENT TAX LITIGATION: A VIEW FROM THE BENCH

JUSTICE RICHARD EDMONDS*

I INTRODUCTION

The title to this paper is deliberately generic to afford me the licence of making observation and comment on a wide variety of disparate issues arising over the last twelve months which legitimately fall within the rubric of tax litigation.

For a start there have been at least two important cases decided by the High Court of Australia – *Commissioner of Taxation v McNeil* (2007) 229 CLR 656 (*McNeil*): extending the general law concept of income beyond that which was thought to be its boundary, although, as I foreshadowed in the paper I presented to this Conference last year, that result was not surprising have regard to what was said by the majority in *Commissioner of Taxation v Montgomery* (1999) 198 CLR 639 (*Montgomery*); and *Bluebottle UK Limited & Ors v Deputy Commissioner of Taxation & Anor* [2007] HCA 54 (*Bluebottle*): which placed a limitation on the Commissioner’s powers to require withholding of amounts on account of income tax liabilities of non-residents which limitation, two judges of the Federal Court had previously independently concluded did not impede the operation of s 255 notices in the way in which the High Court ruled. I shall return to these cases later.

There have been a number of important cases decided by the Full Federal Court, at least if one assesses that importance by reference to the success of the losing party in securing special leave to appeal to the High Court: *Raftland Pty Ltd v Commissioner of Taxation* (2007) 65 ATR 336 (*Raftland*): a case involving the ‘trust stripping’ provisions of s 100A of the *Income Tax Assessment Act 1936* (Cth) (‘the 1936 Act’) where the taxpayer was successful in obtaining special leave to appeal against the orders of the Full Federal Court and which will be heard by the High Court next week; *Futuris Corporation Ltd v Commissioner of Taxation* (2007) 159 FCR 257 (*Futuris*): a case involving the validity of an assessment to give effect to a determination made under Part IVA of the 1936 Act where it was found, as a fact, that the Commissioner knew the amount of taxable income and the tax assessed thereon were wrong, where the Commissioner was successful in obtaining special leave to appeal against the orders of the Full Federal Court; *WR Carpenter Holdings Pty Ltd v Commissioner of Taxation* (2007) 161 FCR 1 (*Carpenter Holdings*): a case where the taxpayer’s entitlement to particulars of matters taken into account by the Commissioner in exercising his discretion to make determinations under subss 136AD(1)(d), 136AD(2)(d) and 136AD(4) of the 1936 Act were in issue, where the taxpayer was successful in obtaining special leave to appeal against the orders of the Full Federal Court in respect of the first two subsections (special leave in respect of the third subsection was not sought); and finally, but by no means least, *Reliance Carpet Co Pty Ltd v Commissioner of Taxation* (2007) 160 FCR 433 (*Reliance Carpet*): where the issue was whether Division 99 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (‘the GST Act’) applied to a deposit forfeited in

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consequence of the rescission of a contract for the sale of land where the Commissioner was successful in obtaining special leave to appeal against the orders of the Full Federal Court.

I had more than a hand in each of these cases so I cannot claim impartiality in respect of the result in the Full Federal Court or the process of reasoning by which the Court got to that result in each case. In any event, whether or not a particular case is seen as deserving of a grant of special leave is a matter for the justices of the High Court and when the balance, infrequently as it might seem, falls in favour of a grant of special leave, quite often it is considerations which previously have not been brought to bear on the subject that carry the day. On the other hand, recent experience suggests that when a tax case ultimately comes up to the High Court on appeal, the views and conclusions of the members of the Full Federal Court carry little weight. This has implications going to the certainty of application of the taxation laws but that is a subject going beyond the scope of this paper.

There have been other important cases which have come up to the Full Federal Court where special leave to appeal to the High Court against the orders below was refused: *Cajkusic v Commissioner of Taxation* (2006) 155 FCR 433 (*Cajkusic*) is the case which most readily comes to mind and I shall return to this case later although one aspect of it will likely be dealt with by the High Court in *Raftland*.

The other decision of the Full Federal Court in the last twelve months which has attracted a great deal of critical comment, not so much in the public media, although there has been a degree of 'rub-off' in that area, but in the writings and opinions of those retained by the Commissioner, is the case of *Commissioner of Taxation v Indooroopilly Children Services (Qld) Pty Ltd* (2007) 158 FCR 325 (*Indooroopilly*). Once again this is a case in which I wrote the principal judgment. This case has attracted critical comment, not of the decision on the substantive issue – the Commissioner never sought special leave to appeal the Full Federal Court's orders – but in response to the Court's criticism of the way in which (1) the Commissioner construed and administered the relevant provisions of the *Fringe Benefits Tax Assessment Act 1986* (Cth) ('the FBTA Act') in the face of a number of single judge decisions of the Federal Court pointing to a contrary construction, and (2) his counsel, in submissions, sought to defend that administration. Fortunately, the occasions on which the Court feels compelled to criticise the Commissioner for the way in which he administers legislation for which he is responsible are very few and far between. This is because the Commissioner and his officers aspire to best practice and in the main this is achieved. But like anyone else, the Commissioner and his officers are not perfect and there will be occasions when something falls between the 'cracks in the floorboards'. It is important that the Court remains vigilant to identify these occasions. Infrequent judicial criticism of the kind that was made in *Indooroopilly* is not made lightly; it is made with the object of promoting review of the processes which impelled the Court to make the criticism it did, and to ensure that, to the extent possible, it does not happen again. Sensitivity to such criticism should not be allowed to get in the way of the review process. I am going to return to this matter later in the paper.

Finally, I wish to say something about the case of *Slade Bloodstock Pty Ltd v Commissioner of Taxation* [2007] FCAFC 173 (unreported) (*Slade Bloodstock*) as an example of the way in which the Court is keen to ensure that not only the parties, but the public at large, is aware of the reason why the Court has decided a case in a particular way, even where the respondent to the appeal concedes that its success below was infected with error. My comments in this regard are contextually relevant

to the steps which are about to be taken by the Court to amend its mechanisms, processes and rules to facilitate greater efficiency, expedition and overall management of tax cases coming into the Court for the ultimate benefit of all tax litigants, both the Commissioner and taxpayer alike.

II THE HIGH COURT CASES

A McNeil

It did not take long for 'the knives to be drawn' following the High Court's judgment in *McNeil* in February of last year. The Court's decision has been widely critiqued (see, for example, D H Bloom QC, *Taxpayer's Heaven: The Citylink Decision; The Opposite of Heaven: The Decision in McNeil*, a paper presented to the National Convention of the Taxation Institute of Australia in Hobart in March 2007) and its departure from what was accepted since the inception of income tax in this country, both by the Commissioner and taxpayers alike, as being the position with respect to renounceable rights issued by a company to its shareholders – that they were not income of the shareholder – was seen as being so significant that the government of the day was forced to announce that legislation would be introduced to preserve the status quo: see the announcement by the then Minister for Revenue and Assistant Treasurer, Mr Peter Dutton, on 26 June 2007. Criticism of the Court's decision on this ground is perhaps not as telling as other criticisms referred to below; the majority were obviously aware from their reference at [21] to Parson's *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985) at 87 – 89, that the question whether rights or options issued to a shareholder as a shareholder are ordinary usage income of the shareholder as income derived from his shares had not been considered in any authority. Consequently, it was not as if there was any judicial precedent in the way of the Court coming to the conclusion it did.

What is surprising, and for that reason more susceptible of criticism, is that the issue was raised in the first place. It is difficult to accept that those responsible for raising the issue would not have been aware of the consequences of the High Court's acceptance of the argument. One is reminded of the litigation that arose over thirty years ago, *Commissioner of Taxation v Patcorp Investments Limited* (1976) 140 CLR 247 (*Patcorp Investments*), where the Commissioner successfully took the point that the taxpayer was not entitled to the benefit of a tax rebate under s 46 of the 1936 Act because it was not the registered shareholder, only the absolute beneficial owner. During the course of the hearing it became apparent that the Commissioner's administration of the Act had been to allow the full rebate of tax in situations where the taxpayer was the absolute beneficial owner albeit not the registered shareholder and the High Court raised with counsel for the Commissioner why his position with respect to the case before it should be any different. The only answer available was that in the case before it, the allegation was that the taxpayer was involved in activities which should not receive the benefit of the Commissioner's benevolent administration of the Act in extending the benefit of the s 46 rebate to owners of shares who were not the registered shareholders of those shares. Certainty was only achieved with the introduction of s 45Z into the 1936 Act in 1992, applicable to dividends paid after 17 August 1976, the date the High Court's judgment in *Patcorp Investments* was handed down.

The more telling criticisms of the High Court's process of reasoning in *McNeil* are:

- (1) Its failure to address the ‘convertibility issue’ – where something other than money is received it will not be income unless at the time of its receipt it is convertible into money: *Commissioner of Taxation v Cook and Sherdan* (1980) 42 FCR 403. The High Court seemed to accept (at [27]) that what the taxpayer became entitled to on 19 February 2001 was not the sell-back rights referable to her (which it was accepted had a value of \$514) but rather a chose in action to compel the due administration of a trust, the sell-back rights being assets of the trust. As the commentator referred to above has observed:

There was no evidence as to the value of this chose in action, as the Commissioner had at all times in the Federal Court maintained that the taxpayer was absolutely entitled to the sell-back rights themselves.

- (2) The majority’s reliance on *Eisner v Macomber* (1920) 252 US 189 at 206 – 207 for the reasons advanced in the paper I presented to this Conference last year: *Recourse to Foreign Authority in Deciding Australian Tax Cases* at [41] – [51].

B Bluebottle

Bluebottle was concerned, amongst other matters, with the proper construction of s 255 of the 1936 Act, specifically whether subs 255(1) required the Commissioner to assess a non-resident’s tax liability before the Commissioner could require a third party to pay the tax due and payable by that non-resident. Subsection 255(1) of the 1936 Act relevantly provides:

255 Person in receipt or control of money from non-resident

(1) With respect to every person having the receipt control or disposal of money belonging to a non-resident, who derives income, or profits or gains of a capital nature, from a source in Australia or who is a shareholder, debenture holder, or depositor in a company deriving income, or profits or gains of a capital nature, from a source in Australia, the following provisions shall, subject to this Act, apply:

- (a) he shall when required by the Commissioner pay the tax due and payable by the non-resident;
- (b) he is hereby authorized and required to retain from time to time out of any money which comes to him on behalf of the non-resident so much as is sufficient to pay the tax which is or will become due by the non-resident;
- (c) he is hereby made personally liable for the tax payable by him on behalf of the non-resident to the extent of any amount that he has retained, or should have retained, under paragraph (b); but he shall not be otherwise personally liable for the tax;
- (d) he is hereby indemnified for all payments which he makes in pursuance of this Act or of any requirement of the Commissioner.

In *Elsinora Global Ltd v Healthscope Ltd (No. 2)* (2006) 227 ATR 570 (*Elsinora*) at [51], I said:

The first question of construction which arises is whether the prefatory words of subs 255(1): ‘With respect to every person having the receipt control or disposal of money belonging to a

non-resident', require the person to have that receipt, control or disposal at the time of being served with a notice of requirement pursuant to par (a), or whether it is sufficient that the person subsequently has that receipt, control or disposal even though he did not have that receipt, control or disposal at the time of service of the notice. While the matter is not free from doubt, I have come to the conclusion that it is not necessary for the person to have the receipt, control or disposal of money belonging to the non-resident at the time of service of the notice and that the operative provisions of pars (b), (c) and (d) will be triggered if and when the person, subsequent to service of the notice of requirement pursuant to par (a), has that receipt, control or disposal. Such a construction promotes the section's undoubted legislative function and purpose as a tax collection mechanism. The contrary view would mean that the Commissioner would have to know when a person had the receipt, control or disposal of money belonging to the non-resident and serve him with a notice of requirement pursuant to par (a) before he ceased to have that receipt, control or disposal. In many cases the Commissioner will know that a person will, or is likely to, have the receipt, control or disposal of money belonging to the non-resident, but not when he will have it. The conclusion to which I have come avoids that dilemma. This question was left open by Lindgren J in *Commissioner of Taxation v Wong* (2002) 121 FCR 60 where his Honour said at [24]:

"In order to decide the present case, I need not, and therefore I do not, decide whether, in order for parts (b), (c) and (d) to be enlivened, a person served with a notice under s 255(1)(a) must satisfy the description in the prefatory words at the time of service, or whether it suffices that he does so later and before action is brought. The reason is that in my opinion the recipient of a notice is required to satisfy that description (be a Controller) either at the first, or at either of those two times, but Mr Wong did not satisfy either formulation of the requirement."

Although, a little later his Honour said at [27]:

"The prefatory words are themselves indefinite in point of time. I see no reason why notional words such as "at any time and from time to time" should not be understood to qualify "having" and "derives" in the prefatory words."

which suggests, in my view, that his Honour may well have come to the same conclusion as I have.'

In *Bluebottle* the High Court said (at [95]):

... the central focus of attention in both cases [*Elsinora* and *Wong*] was upon questions of control of moneys of a non-resident and whether notice can be given under s 255 at a time when the person to whom the notice is directed does not have control of moneys of the non-resident. Argument in neither case seems to have been directed to the issue of what is meant by "tax which is or will become due by the non-resident".

But as I noted in *Elsinora* at [52], in *Wong* Lindgren J said (at [28]):

Consistently with this view, par (a)'s reference to "the tax due and payable by the non-resident" is a reference to the tax due and payable by the non-resident on the "income, or profits or gains of a capital nature" derived by him at any time and from time to time. In other words, a notice given under par (a) can be expressed to have an ambulatory or ongoing operation and to require the recipient to pay not only tax that is already due and payable, but tax which may become due and payable in the future, and will do so if the non-resident derives further income. This construction apparently treats "when" not as referring to a time for payment, but as meaning "if". The construction is supported by par (b).

And I went on to say in *Elsinora* at [52]:

I agree that a notice given under par (a) can be expressed to have an ambulatory or ongoing operation and to require the recipient to pay not only tax that is already due and payable, but tax which may become due and payable in the future. As his Honour says, such construction is supported by par (b).

This view of Lindgren J in *Wong* and my view in *Elsinora* was rejected by the High Court in *Bluebottle*. At [75] – [82] the High Court said:

[75] It is to be noticed that s 255(1)(a) obliges the person who has “the receipt control or disposal of money belonging to a non-resident” (the controller) “when required by the Commissioner [to] pay the tax due and payable by the non-resident”. By contrast, s 255(1)(b) gives the controller authority to retain (and requires the controller to retain) “so much as is sufficient to pay the tax which is or will become due by the non-resident”. The commissioner emphasised both the need to give effect to the phrase “the tax which ... will become due” in para (b) and the use of the different phrase in para (a) “the tax due and payable”.

[76] There are two principal points to make about these differences between the two paragraphs. First, para (a) concerns payment; para (b) concerns retention. It is, therefore, not surprising that the provision for payment (para (a)) should deal with what is “due and payable”, and the provision for retention should acknowledge and deal with the possibility that the time for payment of the tax in question may not have arrived when the controller first becomes liable to pay money to the non-resident or money of the non-resident first “comes to him”.

[77] Secondly, the amount of money which is to be dealt with in accordance with para (a) (by payment) is readily ascertained. It is the amount of the tax that is due and payable by the non-resident. The description of the tax as “due and payable” necessarily presupposes that an assessment has been made. The commissioner submitted that para (b) should be read differently, and as speaking “both of the time of assessment and of a time prior to assessment”. It was said that it was sufficient that there should be “an inchoate liability for tax” and that “the tax would become due, whether considered temporally or as a matter of probability”. These submissions should be rejected.

[78] When s 255(1)(b) refers to “the tax which is or will become due by the non-resident” it must be read as referring to an ascertained sum. If the paragraph is not read in that way, the obligation to retain money which is imposed on the controller is an obligation of undefined content. It is undefined because all that may be retained (the controller “is hereby authorised ... to retain”) “out of any money which comes to him on behalf of the non-resident” is sufficient to pay the tax which is or will become due. And it is that amount (and only that amount) which the controller is obliged to retain. And as the facts of the present matter show, if s 255(1)(b) is not read as referring to an ascertained sum, the commissioner may require the controller to retain more than the amount later assessed as due from the non-resident. But that would require the controller, as the commissioner’s first notices did in this case, to retain more than sufficient to pay the tax which is or will become due.

[79] Until the tax payable by the non-resident has been assessed it is not possible to say more than that there may be tax due by the non-resident. It is not possible to say that tax is due or that tax will become due. The prediction that tax may be due (and any prediction of its likely amount) may be able to be made with more or less certainty by a person who is armed with a deal of information, but there is no reason to suppose that the controller of a non-resident’s money would ordinarily, let alone invariably, have that information and be in a position to make any useful prediction about the taxation affairs of the non-resident whose money the controller receives. The present case illustrates why that is so. The taxation liabilities of Cricket and Holdings relate to transactions they are alleged to have made on capital account and yielded a tax liability in the year ended 31 March 2004. The sums of money which Virgin Blue is now alleged to have been obliged to retain were payments in a different tax year and owing to its shareholders on revenue account. Neither the holding of shares by Cricket and Holdings, nor the fact that Virgin Blue was bound to pay the dividend that was

declared, gave any basis for Virgin Blue knowing anything of the relevant Australian taxation affairs of Cricket or Holdings.

[80] Paragraph (b) of s 255(1) should be read as referring to an amount of tax that has been assessed. The phrase “tax which ... will become due” is to be understood as referring to tax which, although assessed, is not yet due for payment.

[81] This construction of s 255(1)(b) gives proper weight to the language used in that paragraph (the tax which is or will become due by the non-resident) when compared with the different expression used in para (a) (the tax due and payable by the non-resident). As Gibbs CJ observed in *Clyne v DCT*, “[t]he word ‘due’ is ambiguous; it can mean owing, although not payable until some future date, or it can mean presently payable”. And as the decision in *Clyne* illustrates, it is necessary to consider expressions like “due”, and “due and payable”, when used in the 1936 Act, in the context of the Act as a whole. When “due” is used in the collocation found in s 255(1)(b), “the tax which is or will become due by the non-resident”, the requirement for specifying the amount of money that meets that description requires that the word “due” is read as meaning assessed as owing.

[82] Once those steps are taken, the obligations to retain and to pay are seen as intersecting obligations. The point of their intersection is the specification of the tax which under para (a) is to be paid when required by the commissioner, and which under para (b) is both the amount that may be retained (the controller “is hereby authorised”) and the amount that must be retained (the controller “is hereby ... required”). Once this intersection between the operation of para (a) and para (b) of s 255(1) is identified, many of the issues that would otherwise arise on the construction urged by the commissioner fall away. It is, however, necessary to consider the statutory setting in which s 255 takes its place. Two aspects of the statutory setting for s 255 require consideration: the history of the section and the other provisions of the 1936 Act that relate to the collection of tax from persons other than the taxpayer.

And at [96] and [97] the High Court said:

[96] It would be wrong to approach the construction of s 255 piecemeal. In particular, it would be wrong to treat s 255(1)(a) as wholly distinct and separate from s 255(1)(b). In that regard, the “trigger” metaphor adopted in *Wong*, though useful, should not be allowed to divert attention from recognising that paras (a) and (b) of s 255(1) have an intersecting operation. As noted earlier in these reasons, the point of that intersection is the amount with which both paragraphs deal: the tax which is or will become due by the non-resident (which defines the amount to be retained) and the amount which is to be paid to the commissioner when required under para (a) (the tax due and payable by the non-resident).

[97] Once it is recognised that content can be given to the obligation imposed by s 255(1)(b) only if an assessment has issued, the operation of the provision, as a whole, can be seen to be that described at [72] of these reasons.

The reference back to [72] of the High Court’s reasons is a reference to the following:

[72] Uninstructed by authority, and considered in isolation from other provisions of the 1936 Act, s 255 takes a form which suggests that its operation can be described as being:

- (a) to oblige persons of the kind described in the chapeau to s 255(1) to pay the tax assessed as due and payable by a non-resident who meets the relevant characteristics identified in that chapeau (s 255(1)(a));
- (b) to permit the person paying the tax to recoup the tax paid or to be paid by retaining sufficient out of the money of the non-resident coming into the payer’s hands and to oblige the person to retain sufficient of the non-resident’s money to do so (s 255(1)(b));

- (c) to extend the notion of money of the non-resident in the hands of the payer to include amounts which the payer is liable to pay the non-resident (s 255(2)) but subject to the presently irrelevant qualification made by s 255(2A);
- (d) to limit the liability of the payer to the amount that comes into the hands of the payer (s 255(1)(c));
- (e) to give the payer indemnity for all payments made in pursuance of the Act (s 255(1)(d)); and
- (f) to make like provision with respect to the Commonwealth, a state or an authority of the Commonwealth or a state (s 255(3)).

III THE PENDING HIGH COURT CASES

For obvious reasons – in particular my involvement in the Full Court decisions below – I do not think it appropriate for me to comment at large on the decisions in *Raftland*, *Futuris*, *Carpenter Holdings* and *Reliance Carpet*. Each raises its own discrete issues and they are undoubtedly issues of importance not only to the Commissioner's administration of the legislation with which each is concerned, and to the litigants in the relevant proceedings, but to taxpayers generally.

Apart from factual issues going to whether what was involved, or part of what was involved, was a sham, *Raftland* raises a number of interesting issues in relation to the taxation of trust income under Division 6 of Part III of the 1936 Act, specifically the operation of s 100A, and in particular subs 100A(3A); whether the rule in *Upton v Brown* (1884) 26 Ch D 588, that losses in one year must, in the absence of any contrary direction in the trust instrument, be made up out of profits of subsequent years and not out of capital, has application where income and capital interests are coterminous; as well as the effect of the defeasible provisions of the trust deed on a beneficiary's claim to be presently entitled to income of the trust fund.

Futuris raises for the first time in the High Court the issue of whether an assessment which the Commissioner knows at the time of issue to be excessive as to both taxable income and tax assessed thereon, is a *bona fide* exercise of the power to assess and, if not, whether it is a valid assessment protected by ss 175 and 177(1) of the 1936 Act.

Carpenter Holdings raises for the first time in the High Court the extent to which a taxpayer can assail assessments in reliance on Division 13 of Part III of the 1936 Act by seeking judicial review of the exercise by the Commissioner of discretions under subs 136AD(1)(d) and (2)(d) of that Act. This, in turn, raises the issue of the nature of the discretions – whether they are substantive or procedural and, if the latter, whether the ultimate answer is dependent on the answer to the intermediate question.

Reliance Carpet is the first GST case to find its way into the High Court. It has its own factual context and, indeed, a specific Division of the GST Act (Division 99) devoted to that factual context, namely, a deposit forfeited in consequence of a failure to perform the obligation for which the deposit is held as security. The real issue in the case is whether one can identify a supply for which the forfeited deposit is the consideration.

IV CASES WHERE SPECIAL LEAVE WAS REFUSED

The Commissioner sought special leave to appeal from the orders of the Full Federal Court in *Cajkusic* but this was refused. At the risk of criticism of impartiality because of my involvement in that decision, I venture to suggest that it did more to clarify the law relating to the taxation of trust income than many cases before it. Some

commentators might not agree by reference to unusual examples, however, as a member of the Court, I can live with those critiques.

Subject to what might fall from the High Court in *Raftland* in relation to the applicability of the rule in *Upton v Brown* where the income interests and capital interests in the trust fund are coterminous, it is to be hoped that, in the interest of clarity and certainty, the provisions of Division 6 of Part III of the 1936 Act will, on a going forward basis, be administered in accordance with the principles laid down in *Cajkusic*. If it is of any comfort, the Commissioner's Impact Statement on the case issued on 12 September 2007 suggests that they will be.

A Indooroopilly

As I have already mentioned, of all the cases decided over the last twelve months, the one that has attracted the most attention by way of observation and comment has been the Full Court's decision in *Indooroopilly*; not because of the substantive issue it decided, although the importance of the Full Court's conclusion on that issue should not be under-estimated, but because of the comments of two members of the Court (Allsop J and myself – the third judge, Stone J, agreeing with our comments) on the Commissioner's administration of the relevant provisions of the FBTA Act, in the face of earlier decisions of single judges of the Federal Court which held that the construction which formed the basis of the Commissioner's administration of those provisions was wrong.

I gave the principal judgment on the substantive issue with which Stone and Allsop JJ agreed. The background facts are well-known and it is both unnecessary and irrelevant for present purposes to refer to them in great detail. Shares in a public company were issued to the trustee of a share plan under which employees of various employer companies might eventually take, but in the year of tax in which the shares were issued it could not be said of any specific employee that the employee would take. The issue before the Court was whether the definition of 'fringe benefit' in s 136(1) of the FBTA Act required the identification of a particular employee at the 'provision time' in respect of whose employment the benefit was provided. Like the decisions of the single judges of the Court who had previously considered this issue – Kiefel J in *Essenbourne Pty Ltd v Commissioner of Taxation* 2002 ATC 5201; Hill J in *Walstern Pty Ltd v Commissioner of Taxation* (2003) 138 FCR 1; *Spotlight Stores Pty Ltd v Commissioner of Taxation* 2004 ATC 4674 (Merkel J); *Caelli Constructions (Vic) Pty Ltd v Commissioner of Taxation* (2005) 147 FCR 449 (Kenny J); and *Cameron Brae Pty Ltd v Commissioner of Taxation* 2006 ATC 4433 (Ryan J) – the Full Court answered this question in the affirmative.

But it is the observations of Allsop J and myself in relation to the Commissioner's submissions on the respondent's notice of contention which have attracted most comment.

Allsop J observed (at [3] – [7]):

I wish, however, to add some comments about the attitude apparently taken by, and some of the submissions of, the appellant. From the material that was put to the Full Court, it was open to conclude that the appellant was administering the relevant revenue statute in a way known to be contrary to how this Court had declared the meaning of that statute. Thus, taxpayers appeared to be in the position of seeing a superior court of record in the exercise of federal jurisdiction declaring the meaning and proper content of a law of the Parliament, but the executive branch of the government, in the form of the Australian Taxation Office, administering the statute in a manner contrary to the meaning and content as declared by the

Court; that is, seeing the executive branch of government ignoring the views of the judicial branch of government in the administration of a law of the Parliament by the former. This should not have occurred. If the appellant has the view that the courts have misunderstood the meaning of a statute, steps can be taken to vindicate the perceived correct interpretation on appeal or by prompt institution of other proceedings; or the executive can seek to move the legislative branch of government to change the statute. What should not occur is a course of conduct whereby it appears that the courts and their central function under Chapter III of the Constitution are being ignored by the executive in the carrying out of its function under Chapter II of the Constitution, in particular its function under s 61 of the Constitution of the execution and maintenance of the laws of the Commonwealth.

It is the function of the courts exercising federal jurisdiction to declare the meaning of statutes of the Commonwealth Parliament in the resolution or quelling of controversies. To quote Marshall CJ in *Marbury v Madison* 5 US 87 at 111 (1803):

“It is, emphatically, the province and duty of the judicial department to say what the law is.”

This passage has been recognised as central to the administration of justice and to the relationship between the judiciary and executive in this country: *Attorney-General (NSW) v Quin* (1990) 170 CLR 1 at 35-36; *Corporation of the City of Enfield v Development Assistance Commission* (1999) 199 CLR 135 at 152-154 [42]-[44] and *Truth About Motorways Pty Ltd v Macquarie Infrastructure Investment Management Ltd* (1999) 200 CLR 591 at 635 [116].

Considered decisions of a court declaring the meaning of a statute are not to be ignored by the executive as inter partes rulings binding only in the earlier lis. As Mahoney J (as his Honour then was) said in *P & C Cantarella v Egg Marketing Board* [1973] 2 NSWLR 366 at 383:

“The duty of the executive branch of government is to ascertain the law and obey it. If there is any difficulty in ascertaining what the law is, as applicable to the particular case, it is open to the executive to approach the court, or afford the citizen the opportunity of approaching the court, to clarify the matter. Where the matter is before the court it is the duty of the executive to assist the court to arrive at the proper and just result.”

There was some inferential suggestion in argument that the appellant was somehow bound by legislation (not specifically identified) to conduct his administration of the relevant statute by reference to his own view of the law and the meaning of statutory provisions, rather than by following what the courts have declared. It only need be said that any such provision would require close scrutiny, in particular by reference to issues raised by s 15A of the Acts Interpretation Act 1901 (Cth).

I made the following observations at [43] – [47]:

At [12] above, I referred to the reasons relied on by the Commissioner for his answer to question 1. Those reasons included the following statement:

“The definition of ‘fringe benefit’ also refers to a benefit being provided in relation to ‘an employee’, and for reasons outlined in paragraphs 45 - 49 of TR 1999/5 the ATO considers a fringe benefit can arise notwithstanding that a benefit provided to a trust may not be provided in respect of a specific employee.

Whilst Kiefel J’s views in the *Essenbourne* case [2002] FCA 1577 about the proper interpretation of the definition of a fringe benefit in the fringe benefits tax law are contrary to the views expressed in Taxation Ruling TR 1999/5, the Commissioner has determined that as the *Essenbourne* case is not an appropriate vehicle to test the issue with the Full Federal Court, the views expressed in TR 1999/5 will remain the ATO position.”

In written submissions, the Commissioner put his position in the following way:

- “7. The Commissioner was not compelled to follow *Essenbourne* and the other single judge decisions when he ruled on the respondent’s ruling application or when he determined the objection against the ruling which was made.
8. The fact that there are single judge decisions on the meaning of the definition of “fringe benefit” does not mean that the Commissioner was bound to follow those decisions as against taxpayers who were not privy to those decisions: *Business World Computers Pty Ltd v Australia Telecommunications Commission* (1988) 82 ALR 499 at 504.
9. There is no principle of estoppel that would bind the Commissioner to apply the single judge decisions to which the respondent was not a party, in relation to the application of the FBTA Act to the arrangement the subject of the respondent’s ruling request.”

When challenged from the bench that a proposition such that the Commissioner does not have to obey the law as declared by the courts until he gets a decision that he likes was astonishing, the Commissioner submitted:

“The [Commissioner] seeks to make clear that the propositions put in paragraphs 8 and 9 were in response to the respondent’s contentions and were not put as a broader proposition that the appellant is entitled to disregard judicial decisions contrary to the rule of law in the exercise of his statutory powers. On the contrary, the [Commissioner’s] position is that by this private ruling he seeks to have the full court reconsider the first instance decisions because he is mindful of his obligations to apply the law as declared by the courts. It is only in very confined circumstances where the Commissioner would not follow a decision of a single judge of the Federal Court. He was not able to appeal from the observations in *Essenbourne* in view of the finding on the facts on the income tax case. In *Walstern* the relevant observations were obiter and there was no order against which the Commissioner could appeal. In *Caelli* the Court determined the FBT appeal in the Commissioner’s favour “on the assumption” of the correctness of *Essenbourne* and there was no order against which the Commissioner could appeal. The Commissioner has appealed the *Essenbourne* construction in each of the three cases in which he has been able, being *Spotlight Stores* (where the Full Court did not determine the issue), *Cameron Brae* (the appeal is yet to be heard) and this case.”

In response, the respondent submits that if the Commissioner disagreed with the decision of Kiefel J on the fringe benefits tax issue, the appropriate course was for him to have appealed. In specific response to the Commissioner’s submission asserted in [45] above, that the findings of fact on the income tax case precluded an appeal, the respondent says that an examination of *Essenbourne* reveals no such findings – see in particular [33] to [36]. I am inclined to agree, particularly having regard to the terms of subs 148(1) of the FBTA. The respondent also pointed out that the Commissioner explained his reasons for not appealing on a different basis in his Media Release of 14 March 2003:

- The Court held that an income tax deduction was not allowable for an amount contributed by a company to an employee incentive trust because the payment was simply a distribution of the company’s profits to the three principals of the company
- However, the Court disagreed with the Tax Office’s view that fringe benefits tax should apply, *but given the scheme was rendered ineffective by denying deductions, the Tax Office did not appeal to the Full Federal Court.* [Emphasis added]”

At the time the Commissioner issued the ruling, Hill J in *Walstern* had indicated that, in his view, Kiefel J's construction was 'clearly correct' and Merkel J in *Spotlight Stores* had indicated his satisfaction that both those decisions were not clearly wrong and that he intended to follow them. In those circumstances, faced with the ruling application, in my opinion, it was incumbent on the Commissioner, having taken the view that findings of fact precluded him from appealing *Essenbourne* – a view with which I have already expressed my disagreement – either to follow the construction embraced in those cases or seek a declaration from the Court as to the proper construction and apply that construction in the ruling.

The first comment of importance may have fallen from the lips of Gleeson CJ on the hearing of the special leave application in *Petroulias v The Queen* No. S478 of 2006; [2007] HCA Trans 092 on 2 March 2007. The transcript records:

“GLEESON CJ: It is surprising that a circumstance could arise in which Justice Allsop should feel it necessary to say what he said in his reasons in paragraphs 4 and 7, for example.

MR HASTINGS: Yes, I am not aware of that, your Honour, but I can say that in relation to the ...

GLEESON CJ: It sounds as though somebody needs some instruction in basic civics.”

In an article entitled *The relationship between the Commissioner of Taxation and the Judiciary*, published in *Taxation in Australia* Vol. 41 No. 11, June 2007, the Honourable Daryl Davies QC was highly critical of the observations made by Allsop J, and even more critical of my own observations. In relation to Allsop J's observations at [6], Mr Davies wrote:

If his Honour's remarks were read merely as an exhortation to the Commissioner not to disregard decisions of courts of law, there may be no difficulty with them. There would be no difficulty in the Commissioner's adhering to them, for the Commissioner does not ignore decisions of the courts. However, the remarks of Allsop J appear to go further than an exhortation. Allsop J said that the Commissioner's course of action “should not have occurred.”

In relation to my observations at [47], Mr Davies wrote:

With due respect to his Honour, it would have been entirely inappropriate for the Commissioner at any stage to seek a declaration from the Court as to the proper construction of s 136(1). The Court is not empowered to give advisory opinions on matters of law and the Commissioner is not empowered to seek one. The Commissioner was requested by Indooroopilly Children Services (Qld) Pty. Ltd. to give a private ruling and the Commissioner was bound to comply with that request, not to seek a declaration from the Court.

He concluded his article in the following terms:

In Indooroopilly, responsible counsel were seeking to have the important issue as to the interpretation of s 136(1) decided at an appropriate level in the Federal Court.

It is difficult to understand why the Court considered that there was impropriety in the Commissioner's doing that which he had a function and duty to do.

Hopefully, these events will amount to little more than a hiccup in the longstanding cordial relations between the Commissioner and the Court.

The next public comment came in a speech delivered by the Commissioner to the Law Council of Australia Rule of Law Conference in Brisbane on 1 September last. Under the heading ‘*Indooroopilly* and use of declaratory proceedings’ the Commissioner wrote:

Indooroopilly and use of declaratory proceedings

In instances where the law is ambiguous, an appropriate avenue for resolution may be through the courts to obtain judicial clarification of the law. We took this approach recently with regard to deductions claimed in employee benefit arrangements. We consistently won these cases on the basis that the companies were not entitled to deductions under s.8-1 of the *Income Tax Assessment Act 1997*. [*Essenbourne Pty Limited v Commissioner of Taxation* 2002 ATC 5201; *Walstern Pty Ltd v FC of T* 2003 ATC 5076; *Kajewski & Ors v FC of T* 2003 ATC 4375; *Cajkusic & Anor v FC of T* 2006 ATC 2098; *Cameron Brae v FC of T* 2006 ATC 4433]. However, concerned by the possibility of the “holy grail” of deductibility and no fringe benefits tax in relation to such schemes, [*Walstern Pty Ltd v FC of T* 2003 ATC 5076, 5078 where Hill J said: “The ability of a private company employer to obtain unlimited deductions for contributions made to a superannuation fund benefiting employees who are directors and shareholders without either the trustee of the fund being liable to pay tax on the amounts contributed or the employer being liable to pay fringe benefits tax must be the holy grail for tax planners.”] and armed with our understanding of the policy intent of the relevant provisions and a view that we had reasonable prospects of success, we sought to have the FBT issue tested by the Full Federal Court, notwithstanding decisions by single judges contrary to our submission. This course of action culminated in the Full Federal Court case of *Commissioner of Taxation v. Indooroopilly Children Services (Qld.) Pty. Ltd.* [[2007] FCAFC 16].

There is a long history to this matter which arose following the Court’s decision in December 2002 in the *Essenbourne* case. [2002 ATC 5201]. This case involved an employment benefit trust scheme in which the Court decided that the taxpayer was not entitled to a deduction for its contribution to an employee incentive trust. The Court also decided that the contribution was not subject to FBT. [*On 14 March 2003 we published a fact sheet stating that we proposed to further test the Court's construction of the FBT law, explaining also that we did not appeal this aspect of the decision in view of the Court's findings that the payments were not in respect of employment, in which case FBT had no application, and because we had succeeded on our primary argument. In hindsight it may have been better to appeal, notwithstanding these reasons, if we had known that this was open to us.*]

The Court in *Indooroopilly* criticised our course of action. The essence of the criticism being that we should have followed the single justice decisions or promptly initiated other court proceedings, such as seeking a declaration from the Full Court on the FBT issue.

It is important that we explore opportunities for improving the litigation process including particularly the timeliness of law clarification on important issues.

Following on from the comments by the Federal Court we obtained advice from the Commonwealth Solicitor-General, David Bennett QC, the Chief General Counsel of the Australian Government Solicitor, Henry Burmester QC and other legal counsel on the following matters:

- the use of declaratory proceedings to resolve taxation disputes; and
- whether the Tax Office must always follow a single instance decision of a judge.

...

Declaratory Proceedings

The Solicitor-General and counsel have advised that it would not usually be appropriate for the Commissioner to seek to use declaratory proceedings to resolve taxation disputes. In many cases, a declaration from the court would not be available to test an interpretation of the law because the question would be hypothetical or advisory. The advice confirms that the usual objection and appeal processes involving assessments and private rulings should be used to resolve issues between a taxpayer and the ATO. [See also *Daryl Davies QC, 'The relationship between the Commissioner of Taxation and the Judiciary.'* *Taxation in Australia, Volume 41, No. 10 May 2007, pp 630 – 633*].

Single Judge Decisions

The Solicitor-General and counsel have confirmed their earlier advice that the ATO is not required to follow a single judge decision if, on the basis of legal advice, [*Legal advice provided by Solicitor-General Henry Burmester QC on 16 January 2006 advises that internal ATO legal advice provided by an appropriate officer would constitute sufficiently robust and credible advice for this purpose*] there are good arguments that, as a matter of law, the decision is incorrect and prompt action is being taken to clarify the position. In the rare circumstances where the Commissioner does not appeal a decision which is considered incorrect, the ATO will seek to take prompt action to test the issue before the Full Court. [*D Davies QC, op. cit.*]. It is our intention in all such cases to act with “due propriety”.

At the same time, the Commissioner released advice he had received from the Commonwealth Solicitor-General, Mr David Bennett QC, the Chief General Counsel of the Australian Government Solicitor, Mr Henry Burmester QC and Mr James Hmelnitsky of Counsel. The advice is dated 18 June 2007. At the same time the Commissioner also released two anterior opinions from Messrs Bennett and Burmester, the first dated 15 December 2005 and the second dated 16 January 2006. In the more recent opinion, Messrs Bennett, Burmester and Hmelnitsky were asked to advise on a number of questions concerning, *inter alia*, my suggestion that the Commissioner might have recourse to declaratory proceedings to clarify the correct legal position. At [11] they advised:

11. Despite the stark alternative posed by Edmonds J, it is not entirely clear how he considered that declarations could be sought in all cases, given the well established limitations on their use, the existence of the assessment and private ruling systems and the procedures for challenging them. It may be that his Honour had in mind that the Commissioner, instead of ruling, should have sought a declaration as to the fringe benefits tax liability of the taxpayer. If that is what his Honour had in mind then there are various considerations, discussed below, as to why that will generally be inappropriate. He appears to have envisaged, however, that the Commissioner would seek a declaration as to how he should rule. If that was the course his Honour had in mind then there are, in addition [sic] to the general considerations, more serious obstacles which we discuss in the following paragraphs.

In response to the specific questions raised for advice they wrote (at [64] – [74]):

64. In light of the above, we answer the questions as follows.

- (a) What process should the ATO follow to challenge perceived incorrect views of the taxation laws expounded by the judiciary in a way that is consistent with the Commissioner’s obligations to administer the law as interpreted by the judiciary?
65. The Commissioner should normally use private rulings or the issue of assessments, rather than declarations, in order to test interpretations of the tax law. Declarations have a

- number of limitations. They require a contradictor. They cannot be used to answer hypothetical questions and they are more easily sought by a taxpayer than by the Commissioner. They will not necessarily lead to a final determination about a taxpayer's tax liability.
66. The more important issue is that steps be taken quickly to identify a suitable case involving a private ruling or assessment to test a decision that is considered incorrect. If a suitable case can be found and proceedings by a taxpayer brought, at that stage there may be case management options such as a stated case or referral to the Full Court that may assist speedily to resolve the issue in an authoritative way.
- (b) To what extent is the process suggested in previous joint opinions given by the Solicitor-General and Chief General Counsel consistent with the approach suggested by the Court in *Indooroopilly* and to what extent, if any, does the process need to be altered having regard to the Court's observations in *Indooroopilly*?
67. We do not consider that the recent decision in *Indooroopilly* requires us to change the views expressed in the earlier advice. The problem in *Indooroopilly* appears to have arisen from a perception that the Commissioner was clinging to an interpretation of the law that had been disagreed with by a number of single instance judges, and that prompt action had not been taken to have this issue resolved by the Full Court.
68. We do not consider that the critical comments of the judges in *Indooroopilly* can be taken as meaning that the ATO must always follow a single instance decision of a judge. For the reasons previously given, that is not required if there are good arguments that, as a matter of law, that decision is incorrect and action is being taken to clarify the position. That does not mean that in issuing private rulings the Commissioner is generally free to ignore judicial decisions. However, where there is a concern with a particular interpretation and the Commissioner intends to issue a ruling contrary to prevailing judicial opinion, we consider that an early test case is the appropriate procedure.
69. In *Indooroopilly*, while the ATO saw it as a test case, that was not how the Court saw it. This may partly have been because at the time of the ruling there were already a number of judicial decisions that had considered the issue yet the ruling had appeared to ignore or give little weight to them. It was probably the perception that the Commissioner stuck doggedly to his preferred interpretation, regardless of authority, that gave rise to the criticism by the Court in *Indooroopilly*. Whilst a quicker test of the issue should probably have occurred, even if that involved an appeal in a case that was not otherwise an ideal test case, it is unclear precisely what course should have been taken. In particular, we do not express any concluded view about whether *Essenbourne* or *Spotlight Stores* was necessarily the appropriate case for that purpose, or whether the observations of *Edmonds J* in relation to the appeal in *Essenbourne* at paragraph [47] of *Indooroopilly* are correct. Nevertheless, once there is a series of decisions expressing the same view it will always be more difficult to justify a private ruling that ignores those decisions even for the purpose of a test case, and legislative change may be necessary.
70. As indicated in the earlier advice, if the ATO considers that the interpretation of the tax laws in a given case is wrong, it is important that prompt action be taken to test the issue, that there be legal advice that supports the view that the decision is legally wrong and that the Commissioner publicly indicate the reason for his actions and his proposed course.
71. He should until the issue is resolved, so far as possible, avoid acting in a way affecting the affairs of similarly affected taxpayers that could give rise to accusations of inconsistency. This may involve putting assessments, rulings, objections or appeals on hold so far as possible pending resolution of the test case, advising affected taxpayers of the reasons for the apparent delay and explaining the steps being taken to resolve the legal issue in question. This course will not, however, be convenient to every taxpayer and it is possible that the Commissioner will have no choice but to continue with the objection and appeals process in relation to other taxpayers in any event: section 14ZYA of the Administration

Act. Time limits applicable to the Commissioner may also require assessments to be issued notwithstanding the fact that the issue remains unresolved. These are practical considerations that can only be addressed case by case.

- (c) Should the Commissioner use declaratory proceedings, as suggested by Edmonds J, or other types of proceedings to obtain a prompt determination by the courts of questions that the ATO thinks have been wrongly decided but for one reason or another the Commissioner has been precluded from appealing or decided not to appeal?

72. For the reasons already given, we consider that in most situations it will be inappropriate for the Commissioner to seek to use declarations as a way to test interpretations of the tax law he considers incorrect. In many cases, a declaration will not be available at all because the question will be hypothetical or advisory. There may conceivably be situations where a declaration will be appropriate but generally we consider that the use of private rulings or assessments will continue to provide the best way to test an issue.

73. The best way to test issues is to identify test cases quickly and use references to Full Courts or other case management procedures to enable an early hearing. It is important from a public perception point of view that test cases be brought not merely because the Commissioner considers a previous case to be wrong but only where he also has legal advice that suggests the decision is wrong as a matter of law. As earlier advice indicated, the legal advice can include advice from within the ATO. What is important, however, is that the legal advice look objectively at the issue in terms of available legal argument. It is not sufficient to conclude that the interpretation given by the courts does not accord with the original intent.

- (d) Should the Commissioner use declaratory proceedings to determine whether his proposed change of position in relation to certain managed investment schemes in the agribusiness sector is correct?

74. Whatever course of action might be open to a taxpayer (as to which see paragraph 51 above), the Commissioner should not attempt to have this issue resolved in proceedings for declarations. The Commissioner should instead adopt the course suggested in the earlier opinions, namely to identify a matter in which a ruling on the issue has been sought, issue a ruling on the basis of the Commissioner's view and, in the event that the taxpayer objects against the ruling, conduct the resulting appeal under Part IVC of the Administration Act as part of the test case programme. The Commissioner should then use appropriate case management procedures, including an application to have the matter determined by a Full Court if otherwise appropriate, in order to obtain an early resolution of the issue.

Subsequently, on 22 November last, Mr Bruce Quigley, Second Commissioner of Taxation, Law, gave a speech to the Australian Petroleum Production & Exploration Association's annual conference in Hobart. Under the heading 'Declaratory Orders' Mr Quigley refers to both the paper published by the Honourable Daryl Davies QC referred to above and the opinion of Messrs Bennett, Burmester and Hmelnitsky. He writes:

Declaratory Orders

The Commissioner recently sought legal advice regarding the appropriateness of seeking declaratory orders from the Federal Court to clarify contentious points of law. The Solicitor-General and counsel have advised that it would not usually be appropriate for the Commissioner to take this course of action.

The advice indicates that the Commissioner should follow the process set down in Part IVC of the *Taxation Administration Act 1953*. This enables a matter to be referred to the Court where a taxpayer objects to an assessment or private ruling made by the Commissioner.

This advice has been endorsed by the Honourable Daryl Davies QC who has publicly expressed the view that justice and certainty are more appropriately served by the existing processes provided for under legislation. [*Daryl Davies QC, 'The relationship between the Commissioner of Taxation and the Judiciary,' Taxation in Australia, Volume 41, No. 10 May 2007, pp 630 – 633*]. Mr Davies QC points to the responsibility of the Commissioner to bring questions of legal interpretation to the courts for determination. [*Ibid.*]. He also refers to the availability of funding to taxpayers under the Tax Office's Test Case Litigation Program where it is in the public interest to have the matter litigated and the law clarified.

The Solicitor-General and counsel also confirmed advice that the ATO is not required to follow a single judge decision if, on the basis of robust legal advice, there are good arguments that, as a matter of law, the decision is incorrect and prompt action is being taken to clarify the position and communicate the ATO's intention to taxpayers. [*M D'Ascenzo 2007, op cit*].

My responses to these comments and observations are set out below. I hasten to add that they are my responses and I do not speak for either Stone J or Allsop J.

Contrary to the inference in the title to Mr Davies' article, the Court does not have any relationship with the Commissioner – good or bad. While he is, of necessity, a regular and frequent litigant in the Court, there is no relationship between the Commissioner and the Court which places the Commissioner's status as a litigant on a different level from that of any taxpayer litigant. When Mr Davies writes, as he does in the last paragraph –

Hopefully, these events will amount to little more than a hiccup in the longstanding cordial relation between the Commissioner and the Court

I want to assure taxpayer litigants that the Commissioner's relationship with the Court is no different from their relationship with the Court – as a litigant using the Court's services.

I have to say that I was somewhat surprised at the fervour with which Mr Davies put his criticism of the views of Allsop J and myself. With respect, a reader might have better understood that fervour in his defence of the Commissioner's administration and his counsels' submissions had Mr Davies, as a note to the article, disclosed his working relationship with the Commissioner and the identity of his counsel.

With the benefit of hindsight, I would accept that it would not usually be appropriate, nor utile, for the Commissioner to seek to use declaratory proceedings to resolve disputes for the reasons advanced in the joint opinion. On the other hand, I do not regard the background circumstances to the *Indooroopilly* ruling – by that stage the multiple anterior single judge decisions – and the circumstances occurring between the time of the ruling and the hearing before the primary judge (Collier J) – the further single judge decisions – as providing a 'usual' context or environment. So much is recognised at [69] of the joint opinion. With the benefit of hindsight my suggestion of a 'stark alternative' (as it is called at [11] of the joint opinion) may be viewed not as a true alternative, but as an exclamation of exasperation in the face of the Commissioner's refusal to follow the single judge decisions.

Which brings me to the nub of the issue concerning the observations of Allsop J and myself in *Indooroopilly*. In his 1 September speech referred to above, the Commissioner says:

The Solicitor-General and counsel have confirmed their earlier advice that the ATO is not required to follow a single judge decision if, on the basis of legal advice, there are good arguments that, as a matter of law, the decision is incorrect and prompt action is being taken to clarify the position.

This was repeated in the Second Commissioner's speech on 22 November referred to above:

The Solicitor-General and counsel also confirmed advice that the ATO is not required to follow a single judge decision if, on the basis of robust legal advice, there are good arguments that, as a matter of law, the decision is incorrect and prompt action is being taken to clarify the position and communicate the ATO's intention to taxpayers.

In my considered view, neither of these statements fully reflects the tenor of the views expressed at [68] – [71] of the joint opinion. Certainly nothing that was expressed in [69] of the joint opinion finds its way into these passages extracted from the speeches of the Commissioner and the Second Commissioner.

That aside, the views expressed in the joint opinion do not meet with universal acceptance. In a paper presented to the Australian Bar Association conference in Paris on 10 July 2002 in a paper entitled '*Tensions between the Executive and the Judiciary*', the Honourable Justice McHugh AC (as he then was) wrote:

Professor Pearce said [*Pearce, 'Executive Versus Judiciary', (1991) 2 Public Law Review 179*] that he had encountered circumstances where Federal agencies were not prepared to follow judicial or quasi-judicial rulings and were prepared to ignore them when they were inconvenient to them. Taxation Ruling IT2612 provided a clear example. There, the Commissioner of Taxation said that he did not accept the decision in Administrative Appeals Tribunal case V135 and ruled "that where similar facts exist that decision is not to be followed". [*Ibid, at 190.*] No doubt an Executive agency is entitled to disregard a decision where it is truly in conflict with another decision that it thinks is correct. It may sometimes also be justifiable to refuse to follow a decision that is the subject of appeal. But that has problems. Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover, the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid. [*See Owen v Turner (1989) 19 ALD 550*] Even more difficult to justify is the refusal to follow a ruling that is not the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity. The Attorney-General's Department has said that an agency should act inconsistently with a court ruling only on the advice of the Attorney-General's Department. One hopes that this advice is followed meticulously.

Even if one does not accept the view of McHugh J (as he then was) and instead embraces the position as articulated in the extract from the speeches of the Commissioner and the Second Commissioner, nevertheless, by reference to its own criteria, the ATO in the *Indooroopilly* ruling was not entitled to refuse to follow the single judge decisions because prompt action was not taken to clarify the position following *Essenbourne*. The Commissioner might well say that he could not take prompt action to clarify the position; for the reasons I gave at [46] and [47] of *Indooroopilly*, I do not agree. Contrary to what Mr Davies wrote in his article, this particular issue may not be such 'a very small point'. But even if the delay was not within the control of the Commissioner, the inability to take prompt action to clarify the position made it, as I said in *Indooroopilly* at [47], incumbent on the Commissioner to follow the many single judge decisions which were then on foot.

B Slade Bloodstock

The last Full Court case I want to say something about is *Slade Bloodstock*, a case decided towards the end of last year, concerning the application of the FBTA Act to repayments made by an employer to employees of loans previously made by the employees to the employer. It came up to a Full Court via an appeal by the Commissioner from a decision of the Administrative Appeals Tribunal setting aside the Commissioner's objection decision. The primary judge upheld the Commissioner's appeal and the taxpayer appealed to a Full Court.

Prior to the hearing of the Full Court appeal, the Commissioner indicated that he consented to the appeal being allowed, notwithstanding his success before the primary judge. The Court was concerned that if it merely made consent orders upholding the appeal no-one, other than the parties, would understand the basis upon which the Commissioner consented to the allowance of the appeal. It therefore asked both parties to prepare a joint statement detailing an explanation of the circumstances – a summary of the background facts leading to the Commissioner issuing to the applicant the fringe benefit tax assessments, a summary of the proceedings in the Tribunal and before the primary judge and a summary of the reasons why the parties agreed that the appeal should be allowed. A copy of the joint statement was reproduced in the Court's reasons.

On the material before the Court, the Court was of the view that it deserved to be provided with a more detailed explanation of why the Commissioner, having successfully appealed the decision of the Tribunal, was now conceding that the appellant's appeal to this Court should be allowed and submitting that other orders in terms of an agreed short minute of proposed orders should be made. To this end, on the date fixed for the hearing of the appeal, the Court heard from both parties.

As I indicated in [45] above, the Court was concerned that everyone, not just the taxpayer, should be aware of the reasons which underlay the Commissioner consenting to the allowance of an appeal against him, in the face of his success below. This also enabled the Court to properly recognise and endorse the conduct and position of the Commissioner on the appeal. I would hope that when similar situations arise in the future they would be dealt with on a similar basis.

V COURT REFORMS

Over the last six months, the Court has been undertaking a review of the processes and procedures that are in place for the management of tax cases that come into the Court, from the time that an application is first filed until it is finally disposed of. The objectives by reference to which this review is being undertaken are not new; they are:

- (1) To minimise delays in getting a case ready for hearing.
- (2) To minimise the costs that attend any litigation, not only tax litigation, to the extent that this is within the control of the Court.
- (3) To maintain procedural fairness in a context where the taxpayer bears the onus to prove the assessment is excessive.

What is new is the approach to achieving these objectives – the means to the end.

Before detailing the means under consideration, there may be utility if I identify, from my experience, some matters which seem to me to unnecessarily delay the interlocutory process:

- (1) The failure of the parties to identify the real issues in dispute (both factual and legal), at the earliest possible time and to hold the parties to those issues. Of course, there will be cases where the evidence will raise a new factual issue and that may need to be addressed by further evidence. But if all the known issues are identified at an early date, it should be possible, in the vast majority of cases, to make, at the outset, an informed and definitive assessment of the evidence that will be required to address those issues, I don't find it at all helpful for the Commissioner's appeal statement to say, as it often does:

The respondent relies on section 14ZZO of the *Taxation Administration Act 1953*, and except for any facts expressly agreed or admitted in writing, puts the applicant to proof of all facts on which the applicant seeks to rely to establish that the assessment the subject of this application is excessive. None of the facts contained in this statement constitute an admission of proof by the respondent.

- (2) Far too often the parties, but in particular the taxpayer, seek particulars of matters which are not the subject of a proper request; particulars of fact are one thing, particulars of argument are another.
- (3) A failure to properly rely on the curial processes of the Court whether it amounts to a failure to utilise them or unnecessary recourse to them. Notices to admit facts fall into the first category; discovery into the second.

Following a discussion paper presented by Gordon J at a Taxation Workshop conducted under the auspices of the Taxation Committee of the Business Law Section of the Law Council of Australia, that Committee wrote to the Chief Justice supporting the proposals outlined below. Subject to one or two minor variations, those proposals have received the support of the Australian Taxation Office via a letter from Mr Kevin Fitzpatrick, Chief Tax Counsel, to the Chair of that Committee. The proposals are now before the Practice Committee of the Court.

The proposals are encapsulated in the paragraphs below:

- (1) There is no suggestion that the docket system should be abandoned. On the contrary, abandoning the docket system was seen as antithetical to seeking to address the symptoms that attach to all litigation including tax litigation. However, the participants acknowledge that measures need to be adopted to improve the efficiency (in terms of time and cost) in the management of tax cases and to coordinate the management of the work, on a national basis.
- (2) First, a refinement of the panel system so that the judges on each panel (including the tax panel) are judges committed to the subject matter of the panel. The refinement is designed to take advantage of specialist panels while at the same time maintaining the important advantages at trial and on appeal of a court of broad jurisdiction.

- (3) Secondly, the appointment of a 'Tax List/Coordinating Judge' in each Registry to examine all tax cases before that registry, both existing and future, to ensure that:
- (i) like cases are heard together;
 - (ii) common issues wherever they arise are heard together or sequentially but consistently;
 - (iii) information is disseminated appropriately to the judges on the tax panel universally and uniformly;
 - (iv) there is adjustment to allocations of cases, urgent cases, assistance with workload etc.
- (4) In relation to cases (both existing and future), information should be ascertained to enable the tax list judge to know, for example:
- (i) the history of the matter up to the application to the Court;
 - (ii) the legal issues involved;
 - (iii) the amount of tax and penalty in dispute and the extent to which it is outstanding;
 - (iv) the prospects of other matters coming into the Court involving the same taxpayer and the same issues or a different taxpayer and the same issues;
 - (v) whether there are other matters already in the Court involving the same taxpayer and the same issues or a different taxpayer and the same issues and if so, the stage that these matters have reached;
 - (vi) whether the Commissioner and/or the taxpayer regards it as a matter to be 'fast tracked' and why.

The profession would like to be consulted about the form in which information of this kind would be provided. There was concern that there should be a balance between the level and type of information provided and the cost in providing it.

- (5) Procedurally, two significant changes are proposed. First, that if a particular case or issue in a case is considered by one or both parties to need to be fast tracked, that fact and the reasons why the case needs to be fast tracked should be included in the material provided upon filing. By adopting that relatively simple change, that issue will be identified at the outset and will enable the docket judge (prior to the first directions hearing) to consider whether it should be fast tracked and if so, the most efficient means for doing so. To the extent necessary, the Tax List/Coordinating Judge should assist in that process to assist with national management of tax litigation.
- (6) Secondly, having the Court in tax cases adopt in whole or in part the Fast Track protocols. Set out below are some aspects of the Fast Track protocols that the workshop consider essential to addressing the symptoms and causes earlier identified.

First Directions Hearing

- (7) The First Directions hearing is seen as critical. It may be better to rename it as, for example, a scheduling conference. At this hearing, the factual and legal issues should be discussed in detail identifying:
- (i) the facts in agreement;

- (ii) the facts in dispute;
 - (iii) that fact or those facts which one of the parties needs to prove and disprove and why and the most efficient means of undertaking that task. (Having crystallised the factual and legal issues in dispute, general discovery and categories of discovery may be inappropriate and unnecessary.);
 - (iv) the witnesses (including experts) likely to be called with an identification of what issue their evidence is to address;
 - (v) the legal issues in dispute and whether there is a dispute about the applicable principles. If not, what are they?
- (8) In seeking to identify and narrow the factual and legal issues from the outset, it was accepted that (i) key or core documents could be provided to the judge prior to or at the first directions hearing to assist with the process outlined in [7] above and (ii) the parties' lawyers attending the scheduling conference had to have the knowledge and the ability to undertake the tasks just described.
- (9) Two other important steps should be taken at the scheduling conference:
- (i) a trial date or a period within which the trial will be heard should be stated;
 - (ii) the parties should inform the Court not only whether the case is a 'test case' but whether the parties (or one of them) considers it strategic and if so, why.

Ongoing case management

- (10) Ongoing case management by the Court is essential including the monitoring of compliance with directions. The present practice in some cases of the Court (and parties) not looking at a matter between directions hearings has to be eradicated.

Pre-trial conference

- (11) A pre-trial conference should be held a short period before the trial attended by the parties and their lawyers for the purpose of resolving all outstanding issues including, for example, objections to evidence.

25 January 2008

KEYNOTE ADDRESS

**DELIVERING FOR THE COMMUNITY: MAKING TAX AND
SUPERANNUATION EASIER, CHEAPER AND MORE PERSONALISED**

MICHAEL D'ASCENZO*

I INTRODUCTION

A common and devilish error is to mistake the Australian Taxation Office (ATO) with consolidated revenue; but apart from that error there is no devil inherent in either.

The ATO has no vested interest in the amount of tax collected, other than to ensure that it carries out its role of administering legislative systems – namely taxation and significant aspects of superannuation.

The main purpose of Australia's tax laws nevertheless may be to raise funds for consolidated revenue. "For without revenue, government would collapse, society as we know it would disappear, and chaos would follow."¹ However, the revenue referred to is that properly payable under the law, and the quality of administration is a critical intermediating factor for the time impact of a country's tax system.²

Taxation performs other functions as well, including as an instrument of fiscal, social and environmental policy.³ This conference highlights the many of these other aspects of taxation.

The ATO contributes to the wellbeing of Australians indirectly through enabling the beneficial fruits of taxation. It contributes directly through the just achievement of legislative intent and the minimisation of compliance costs.⁴

Understanding this dynamic, the ATO's 'Easier, Cheaper and More Personalised' (ECMP) program has sought to elevate the goal of national efficiency by minimising the sum of taxpayer compliance costs and administrative costs as one of our effectiveness indicators.⁵ Today, I am launching the ATO's *Making it easier to comply 2007-08* booklet which is our annual progress report and future commitment to the community on reducing the tax compliance burden, within the parameters of the law. It outlines in detail current and proposed improvements in our administration. Again no devil here – other than the challenge in their implementation.

* *Commissioner of Taxation, Australian Taxation Office*

1 Charles Adams, "For Good and Evil: The Impact of Taxes on the Course of Civilization", Madison Books, Lanham, 1993, p.1-2.

2 Joel Slemrod, "Why People Pay Taxes: Introduction" in *Why People Pay Taxes*, Joel Slemrod (ed), 1992, p.1.

3 In relation to the latter see generally, Ashiabor, Deketelaere, Kreiser and Milne, "Critical Issues in Environmental Taxation, Volume II", Richmond Law and Tax Ltd, Richmond UK, 2005.

4 See C. R. Alley and D. Bentley, "Tax Design Principles: Remodelling Adam Smith", (2008) 20 *Australian Tax Forum*, 622. There is also likely to be a link between voluntary compliance and the level of compliance costs: see John Hasseldine, "Linkages between compliance costs and taxpayer compliance research", Chapter 2, in Chris Evans, Jeff Pope and John Hasseldine (eds), "Tax Compliance Costs: A Festschrift for Cedric Sandford", Prospect Media Pty Ltd, St Leonards, 2001.

5 See for example, pp. 35, 56-60 and 135 of the *Commissioner of Taxation's Annual Report 2005-06*, and pp. 20, 37-39, 46-8, 50 and 110 of the *Commissioner of Taxation's Annual Report 2006-07*.

We've made a lot of improvements and paved the way for progressive improvements into the future. Not surprisingly, improvements are particularly marked for tax agents, the fillip being that by helping and influencing one tax agent, we help and influence many taxpayers.

Our research shows that people's experiences with us are steadily improving.⁶ But we cannot be lulled into a self-satisfied complacency.

II MAKING IT EASIER TO COMPLY

It is worth reiterating why it is so important for us to make it easier to comply. Firstly we believe that it directly supports better compliance behaviours and outcomes. The easier it is, the more likely people are to voluntarily comply. Secondly it is important in its own right that we administer the system as efficiently as possible with minimum additional burden on the community. And thirdly, at a broader level, many of the improvements we support, such as better record keeping and use of electronic services have the potential to help the community and especially businesses become more productive and internationally competitive.

By consulting and collaborating with the community and co-designing the future of tax and superannuation administration with them, we have the best chance of minimising compliance costs.

The 3Cs, as they've come to be known in the ATO – consultation, collaboration and co-design – are the tools we use to ensure the development of user-centric solutions. Underpinning the 3Cs are our values which govern our dealings with the community and which are consistent with the *Taxpayers' Charter*.⁷

A *Listening to the community*

By working with the community and seeing the tax and superannuation systems from their perspective we can design administrative solutions that make it as easy as possible for taxpayers and their advisers to exercise their rights and meet their obligations.

Following a review of our stakeholder consultative forums in 2006-07 we now use around 50 stakeholder forums to 'listen to the community'. They draw on a diverse membership, reflecting the shape and breadth of the tax and superannuation systems, and include individual taxpayers, business operators, business and industry representatives, and tax professionals.⁸ These consultative forums are outlined in the booklet, and if there is any material gap in the coverage I welcome advice in this regard, but remember that the ATO's primary function is to administer the laws made by parliament and that we are not a policy or law maker.

Recently we took the 3Cs to a new level and agreed to pilot a concept pitched to us by the Council of Small Businesses of Australia (COSBOA) to have a tax officer work with COSBOA as a key relationship management for their members. This will provide an entry point into the ATO for COSBOA members and facilitate a better understanding of the tax compliance issues faced by small business. We're looking to

⁶ *Commissioner's Annual Report 2006-07*, p.37-39.

⁷ The ATO's Corporate Values are listed in its Corporate Plan 2007-08 as being fair and professional; applying the rule of law; supporting taxpayers who want to do the right thing (including being firm with those who don't); being consultative, collaborative and willing to co-design; being open accountable, and responsible. See also the *ATO's Strategic Statement 2006-10*.

⁸ See *Commissioner's Annual Report 2006-07*, pp.81-83.

implement similar arrangements for other associations, reflecting a more personal, flexible and more user friendly approach to helping taxpayers.

III IMPROVING OUR PRODUCTS AND SERVICES – RECENT RESULTS

Many of our recently introduced improvements are being delivered through our transformational change program.

To date, through our change program, we have deployed tax agent and business portals, as well as client relationship, case and work management systems.

By using the client relationship systems when people contact us by phone, letter or in person, we can now quickly get a complete online history of their dealings with us, including copies of correspondence on screen. This allows us to provide a better service.

Skilling programs for our call centre officers mean that they can now answer more phone queries at the initial point of contact.

Much of our work is now logged using a single system and can be distributed electronically to our officers for actioning. Again, when people contact us, we can immediately see where a job is up to and who's working on it. When we complete the change program in 2009 all of our work will be handled this way.

Managing the flow and progress of audit work is now easier because there are fewer systems. We can also see previous audit activity and whether other action is in progress. Our officers have a better understanding of the taxpayer's dealings with us and our dealings with them. All this allows for better differentiation.

The significant efficiencies delivered by the new technology are being felt as noticeable improvements by taxpayers. For example, our Community Perceptions Survey indicated that 82% of people believe the Tax Office is doing a good job. A decade ago the same measure was 55%! The improvement has been most marked in the past five years.

Our call centre client satisfaction surveys have also shown significant improvements over the last two years on a number of fronts, as we have refocused on resolving queries (which have led to longer average handling times per call).

While our change program is driving change at the macro level and for all segments of the community, we have also made considerable improvements to many of our other products and services which are making it easier for people to interact with us.

A Online saves time

1 e-tax

In my first presentation to ATTA as Commissioner, I spoke about masking complexity for taxpayers.⁹ Our electronic income tax return product, e-tax, has consolidated its position as the preferred channel for those who prepare and lodge their own income tax return. Almost two-thirds of self preparers, or 1.9 million, lodged using e-tax in 2007.

Basically, e-tax only requires individual taxpayers to add their facts, which are uniquely within their knowledge. We have further assisted this by pre-filling the electronic income tax returns with information from third parties the individual just needs to check, confirm or amend the information provided. For 2007 returns, we

⁹ ATO, 'It is the community's tax system', speech to ATTA, January, 2006

included bank interest and managed fund information from 24 financial institutions; share dividends from 2 major registries; payment information from the Department of Veterans' Affairs, Higher Education Loan Programme information from the Department of Education, Employment and Work Place Relations, and conducted a limited pilot making PAYG payment summaries available. However our current tax system which includes deductions for work related expenses, tax offsets, and optional systems and choices limits the potential efficiency of pre-filling initiatives.

B Our portals

Enhancements to our business and tax agent portals over the past 12 months provide improved functionality for people who want to deal with us online. Almost two-thirds of tax agents use the tax agent portal frequently in their interactions with us. The number has grown steadily from 48% of agents in October 2004 to 62% in March 2007¹⁰. Furthermore the most recent results indicate 81% of respondents who use the tax agent portal do so on a daily basis with another 14% on a weekly basis.¹¹

Eighty-two per cent of tax agents surveyed in our 2007 'state of the industry' research¹² considered further enhancements to the portal as one of the most important issues we should address.

Since the portal's introduction, we have deployed 10 upgrades, the latest being October 2007. Our total investment for the tax agent portal to date is around \$40 million.

New features include downloadable payment slips for a range of obligations. It also provides an income tax client lodgment report, similar to that which agents can access using the Electronic Lodgment Service. Users can also view, vary and lodge quarterly PAYG and GST quarterly instalments.

This additional functionality is also available from the business portal.

Feedback on this upgrade has been good, particularly in regard to availability of payment slips. A tax agent¹³ on our Lodgment Working Party consultative group has told us that the online payment slips will save her clients time.

With the new payment slips they will see straight away what they owe, and they can just go along to the post office and pay it.

As tax agents we're quite optimistic about the future. The ATO is listening.

In view of the important role BAS service providers contribute to our tax system, we recently made a restricted access view of the tax agent portal available to them to provide more certainty around complying with the law, particularly for the benefit of their small business clients.

We are also making further progress on security arrangements for the tax agent portal. We are transitioning PIN and password users to public key infrastructure which allows tax agents to securely send and receive a greater range of information online.

10 ATO, *TNS Social Research, Biannual tracking of tax agent perceptions of service and usage of channels* March 2007

11 ATO, *TNS Social Research, Biannual tracking of tax agent perceptions of service and usage of channels* March 2007

12 ATO, *TNS Social Research, State of the Industry - tax agents* 2007.

13 ATO, *Making it easier to comply* 2007-08, page 24.

The take up of the business portal has been well below potential. We are looking at how we can increase the attractiveness of the portal to business through the services available, making the security process easier and leveraging off our new small business assistance program.

C More personalised services for intermediaries

To meet tax agents' request to resolve some technical issues directly with appropriately senior tax officers, we consulted with a group of 20 agents across the industry to co-design how this might work.

A pilot service will be commencing shortly. It aims to complement existing arrangements by providing a 'professional to professional' approach.

We also worked with tax practitioners in rural and regional Australia to improve our services for this significant group and address their key concerns.

As a result, we have recently appointed senior tax representatives in our North Queensland, Tasmania and Melbourne sites to provide a local relationship manager service to agents in these areas. We have also commenced the re-introduction of the Regional Tax Practitioner Forums in these areas.

D More personalised assistance for small business

Small business is a diverse sector. Two-thirds of small businesses are home based; one-third of business operators were born overseas; and 39% of small businesses operate in regional Australia.¹⁴

More than 60% of small businesses are in property, business services, construction, finance, primary production and retail.¹⁵ They are also an indispensable part of the export sector – small businesses make up around 42% of Australian exporters.¹⁶

In 2007 we redeveloped our program of assistance for small business. We are seeking to provide assistance that is:

- more business-focused,
- practical,
- easier for business to understand,
- personalised to the needs of small business,
- relevant to the issues a business is facing at a particular time, and
- delivered in a way that best suits the business, including more extensive use of state and local business assistance services, local chambers of commerce, and business and industry associations.

This program differs from the Review of Self Assessment in that it differentiates "guidance" from "advice" allowing the provision of practical guidance without it having to be couched in technical terms which ultimately provides a monopoly for tax practitioners.

Our Small Business Assistance Program offers personal visits, seminars, workshops and phone support and assistance through third parties.

The program provides assistance to business on start up and at other points in the business life cycle, for example at the stage where a business becomes an employer, registers for GST, or experiences difficulties in meeting their obligations.

14 Department of Industry, Tourism and Resources, *Encouraging Enterprise*, Canberra, 2006

15 *ibid*

16 *ibid*

Our research¹⁷ shows that over 70% of businesses report that they believe we are trying to make it as easy as possible for them to comply with their tax obligations. Furthermore, over 60% believe it is easier now than in the past to deal with us.

We believe the program offers good potential to increase the community's confidence in us and Australia's tax and superannuation systems by:

- helping to increase practical certainty for small business, especially those who are new to business,
- building a relationship with businesses that feel more comfortable seeking help, either from us or through others, and
- minimising the costs of compliance for small business.

1 *Dealing with debt*

If people fall behind or are having difficulties, we encourage them to contact us early and let us know their situation – we'll work with them on a solution.

Small businesses with a turnover of less than \$2 million account for about two-thirds of outstanding collectable debt, and have done so for a number of years.

We reviewed our policies, practices and procedures around debt to ensure we are living the Taxpayers' Charter and our corporate values.

It is pleasing that our efforts have helped to reduce the growth of collectable debt¹⁸. Year to date collections of superannuation guarantee charge have already exceeded forecast results by 5.6%.

Independent research conducted for the ATO¹⁹ shows that our efforts to recognise individual circumstances are being recognised. The research shows that the businesses that agreed we take individual circumstances into account in our decision increased significantly from 50% in 2006 to 64% in 2007. This is the highest rating since this question was first asked when the survey commenced.

E *Providing greater certainty for large business*

In 2006 we convened a large Business Symposium and co-designed with business our *Large business and tax compliance* booklet. We also instituted regular visits between senior ATO officers and senior company representatives. These examples of the 3Cs at work are designed to reduce compliance costs and to promote trust and confidence.

We have also been advocating for large business to include tax risks within their risk management processes. According to Ernst and Young's 2006-07 Global Tax Survey, "the importance of managing tax risk is gaining wider acceptance at board level", with Australian companies reporting the most well-established communication between their tax departments and company boards. However, it also found that not all Australian companies are "employing a sophisticated and structured approach to tax risk management."

In January 2007 we wrote to the boards of the top 200 ASX companies and enclosed a copy of *A governance guide for board members and directors*.

17 ATO, *Business Perceptions Survey*, Wave 11, 2007.

18 Growth in collectable debt (that is debt that is not subject to dispute or associated with insolvency) slowed to 6.4% in 2005-06, down from 28% in the previous year. It slowed to 5.4% in 2006-07, and at the same time, we increased collections by 6.6%.

19 ATO, *Business Perceptions Survey* Wave 10 results compared with Wave 11.

The more large business has governance arrangements that include tax risks, the less likely is the need for costly and time consuming audits; and fewer surprises in the form of large tax adjustments that can have both a financial and reputational impact on the company.

At the 2006 OECD Forum on Tax Administration (FTA) meeting in Seoul, there was a recommendation that the OECD guidelines on corporate governance be amended to include tax risks. Although this initiative has not yet been progressed by the OECD, Australia, working with Canada and Chile, agreed at the 2008 FTA meeting in Cape Town to develop draft guidelines for consideration by the FTA members. Another outcome of the 2008 Cape Town FTA meeting was the *Cape Town Communiqué*.

The Communiqué explores the opportunity for an “enhanced relationship” with large business based on risk management, fair, open and responsive administration, and greater transparency by taxpayers. The hypothesis is “that taxpayers who behave transparently can expect greater certainty and an earlier resolution of tax issues with less extensive audits and lower compliance costs.”²⁰

In Australia, we have taken this philosophy further. Our public rulings program is geared towards clarifying the ATO’s position on contentious issues²¹; in 2006-07 we made 20 additional advance pricing agreements and reviewed 11 existing arrangements; we have a streamlined private rulings process for board level tax issues; we have implemented three forward compliance agreements (including with the ANZ on GST and with BP Australia on GST and Excise); and we are exploring with the Corporate Tax Association new ways we can work with business to provide more certainty earlier.

IV IMPROVEMENTS IN 2008 AND BEYOND

The next phase of our change program commences in March 2008. We are replacing a multitude of registration, processing and accounting systems with a single system that will cover all tax and superannuation products. When the program is fully implemented by the end of 2009, it will deliver some of the biggest changes and improvements to the taxpayer experience. However, there will be hiccups and productivity dips in the transition period as we build for the future. In addition, our plans are predicated on our current budget projections and do not include any new and major IT requirements.²²

A For everyone

When our registration, processing and accounting systems are fully integrated, one of the biggest changes will be that most people will have a single statement of account with us.

From April 2008, as well as introducing a new more informative income tax Notice of Assessment, we will be able to show income tax and fringe benefits, higher education loans, and penalty and interest information on the one statement of account.

20 OECD *Cape Town Communiqué*, p.3.

21 In 2006-07, we issued 369 public rulings consisting of 118 public rulings and tax determinations (84 final, 34 drafts, 132 class rulings and 119 product rulings: *Commissioner’s Annual Report 2006-07*, p.96.

22 For example, the schedule for our change program had to be extended to include major IT requirements to support the new superannuation simplification measures.

Then from January 2009, BAS information including goods and services tax and excise is planned to be included on the statement.

As well as a number of tax agent representatives, our Small Business Advisory Group has been working with us to re-design the statement of account. Our research and development work, includes testing in our simulation centre. The single statement of account should make the detail clearer.

One of the members²³, a public accountant with a small business client base, explains the client experience this way:

At the moment most of my clients put the Statement of Account straight in a file. Or they panic and think it's a bill, rather than a statement, much like a bank statement. I'm hoping with the new version people can understand it.

1 Letters, notices and statements

As foreshadowed in the Commissioner's Annual Report 2006-07, we now have a project in course that is all about improving the readability of our letters, including asking the question of whether a letter is the best way to communicate with taxpayers.

In 2009 we will be able to communicate via a person's or business' preferred contact channel.

Also our new integrated system will allow us to better coordinate correspondence and other information services making it easier to for people to understand their obligations and entitlements.

2 Online with ato.gov.au

This year we are starting to redesign our website to improve the look and feel, with progressively improved navigation and search facilities planned through to 2010 to make it easier for people to find the right information quickly.

We are also reviewing online security processes to make sure we have the right balance between usability and the need to protect taxpayer information.

B For individuals

1 e-tax

For Tax Time 2008 e-tax will again include more pre-filled third party information.

New information that will be available, includes Tax Office held data on the Higher Education Loan Programme and prior year deductions, some data from previous years' returns, payment summaries in cases where the employer provides the details to us electronically, private health insurance data from Medicare and information from more financial institutions.

We are also continuing work on making e-tax available on other operating systems with a provisional target of 2009.

2 Lost superannuation

We are looking to introduce an updated lost member register online facility that incorporates search and portability functionality. This will be available in 2009/2010.

23 ATO, *Making it easier to comply* 2007-08, page 16.

3 Greater differentiation to deliver more tailored services

An underlying theme for all our interactions is to increasingly differentiate our handling of a taxpayer's affairs and issues according to their history of compliance and dealings with us, their individual circumstances and their risk profiles.

This is partly supported by the new client relationship and processing systems and also by more sophisticated intelligence and analytics capabilities that we have planned. The latter are seen as essential in supporting greater differentiation, but we still have to secure their funding.

As a consequence we should be able to be less intrusive to those doing or trying to do the right thing, whilst able to better identify those taxpayers people and/or transactions that represent a higher risk.

C For small business

1 Assistance for new to business

Under our new 'Business assistance program' we expect to make over 1000 assistance visits this year. This will enable us to provide practical assistance to small business, and also showcase our online services, including our portals, electronic tools and products, including e-Record and our record-keeping evaluation tool.

This new approach to assisting small business is exemplified in the brochure *Helping small business stay on track*.

2 Aged debt, superannuation debt, and early intervention

We are aiming to reduce the number of debts that are over two years old and also giving a greater priority to outstanding superannuation guarantee charge debts.

We will do this by expanding our automatic dialler technology, referring some debts to external debt collection agencies, and by dedicating more staff to recovering superannuation guarantee charge debts owed to employees.

We are also using risk modelling to better tailor our treatment of taxpayers who have a debt by applying different strategies depending on their individual circumstances. By using this capability, we can better identify taxpayers who benefit from early contact, helping them to avoid problems further down the track.

3 Superannuation

For employers we will be releasing an online calculator for Superannuation Guarantee Charge this year to assist them in completing superannuation guarantee statements.

We intend taking this a step further by linking the data fed into the calculator to the super guarantee statement so that the statement pre-fills as much as possible.

The next step in making it easier for businesses to comply with their super obligations will be facilitating online lodgment of the statement via our portals. This is scheduled for 2009 when we expect to introduce a new business portal.

The new portal will allow businesses to manage their debts online, including entering into payment arrangements through the portal. They will also be able to lodge super guarantee statements in this way. Tax agents will also be able to do this on behalf of their clients using the tax agent portal.

D For large business

We continue to work with large businesses to encourage self-regulation and voluntary compliance. Promoting high standards of corporate governance and managing tax risk in the overall risk management framework is at the heart of our approach.

We are looking to develop innovative ways to promote certainty and reduce risks. For example, we are looking at piloting the concept of a review of a company's annual tax return following lodgment to give earlier certainty on their tax affairs.

E For intermediaries

We will continue our focus on strengthening our relationships with key intermediaries, including tax agents, bookkeepers, payroll providers and software developers.

Recognising the tax practitioner's key role, we are enhancing our advisory and support services to tax agents by providing more personalised and timely services.

Improvements to the tax agent portal in 2008 will enable us to reply to requests for technical assistance via the portal.

If the pilot of our 'professional to professional' service proves successful, we will implement the full service starting in May, offering senior practice managers a single entry point to our services through an account manager.

In the second half of this year, we will have replaced the Phone Services Card with a Tax Agent Services Guide that provides handy information on all our channels, including the portal and Electronic Lodgment System and our phone services.

During 2008, an online tool will be released to help private companies and their advisers comply with Division 7A. Where tax is owed the tool will calculate the minimum yearly repayment required.

We are also developing a suite of training products for new employees of tax agents.

By the end of 2008, we are planning to have improved our tax practitioner phone service with more skilled staff and timely guidance, and provided access to specialists through a booking service.

At this time we also plan to have completed the transition of portal security arrangements from PIN and password to public key infrastructure.

Early in 2009 we plan introduce a new tax agent portal with improved interface, language and additional functionality.

During 2009 we will also introduce client preferencing with regard to how we contact people and their agents and a wide-ranging facility for updating details; and, tax agents will be able to access a client calendar which shows lodgment obligations, activity statements, payments and payment plans.

During January 2009 it will also be possible for tax agents to request that a copy of the Notice of Assessment be sent automatically to them.

In relation to superannuation, an online Self Managed Superannuation Fund auditor tool to assist auditors identify compliance issues and prepare and lodge auditor contravention reports should be available by at the end of 2008.

More generally, the broad themes that emerge from our discussion with tax intermediaries, and tax agents in particular, relate in the main to confidence in the industry and capability issues.

Over half (54%) of surveyed tax agents are optimistic about the future of the tax profession, compared to 39% in 2003. Accountants who are new to the industry (73%)

and overseas trained accountants (72%) were highly optimistic about the future of the accounting industry.

The proportion of tax agents surveyed who indicated they were satisfied with their job has increased significantly, up from 40% in 2003 to 73% in 2007.

The majority (56%) of new accountants surveyed made the decision to study accountancy during high school. The most commonly cited influences on this decision were family (58%), career information at school (43%) and professional association promotions (28%).

Thirty-five per cent of the overseas trained accountants surveyed said the thing that would have made it easier when they had first migrated was if Australia had greater acceptance of overseas qualifications and experience.

Ninety per cent of respondents had professional qualifications, such as CPA, CA or some other recognised accounting qualification prior to migrating. Interestingly, 40% of the overseas trained accountants surveyed completed or enrolled in a professional qualification course since migrating to Australia.

Tax agents surveyed thought that further tax education was important for solicitors, financial planners, bookkeepers and tax practitioners.

Two-thirds of agents thought more education was important for bookkeepers, and at least 60% thought it was important for business proprietors, solicitors and financial planners. Seventy-two per cent thought that more training for tax practitioners on tax legislation was needed, and 80% said more training and advice geared specifically to smaller tax practices was important.

F Whole-of-government

People rightly demand delivery of government programs and services in a seamless way. Moreover, there are efficiencies for Australia in terms of reduced compliance costs and a lower regulatory burden through the use of 'whole of government' approaches.

1 Standard Business Reporting

We are heavily involved in the Standard Business Reporting programme. This Treasury-led programme is about reducing the burden faced by businesses in reporting to government agencies such as the Tax Office, the Australian Bureau of Statistics, and the Australian Securities & Investments Commission, the Australian Prudential Regulation Authority and, potentially, the Offices of State Revenue.

As well as better cross agency coordination and integration where possible, the success of the programme relies heavily on collaboration and co-design with the business community, their intermediaries and financial software developers.

For businesses and their intermediaries, the programme seeks to:

- make wording on forms as consistent as possible across agencies; for example the term 'family name' could be used consistently across government versus 'family name' in one agency and 'surname' in another; and
- enable forms to be pre-filled, as much as possible, directly from information in the businesses' accounting/record-keeping software, and sent electronically via a system that automatically routes the information to the correct agency and then confirms receipt.

A pilot of tax file number declarations using a new co-designed process is expected to commence in 2009 and a range of other transaction pilots involving business, software developers and the agencies are planned for 2009 and 2010.

2 Other whole-of-government initiatives

We are raising awareness of online security through the whole of government initiative, *Stay Smart Online*. We are using our business and tax agent portals to provide links to information and practical tips for protection against security scams and transacting safely online.

In facilitating the use of information in the Australian Business Register, as the Registrar has approximately 70 memorandums of understanding with government agencies to provide information in accordance with the law.²⁴

A review to better position the ABR in supporting whole-of-government activities and to make our activities undertaken as the Registrar more transparent and independent of my role as Commissioner of Taxation is expected to be completed mid year.

Government is also supporting an initiative to integrate state business name registrations with the ABR, pending the Council of Australian Governments' endorsement.

V CONCLUSION

A 2006 World Bank publication, *Where is the wealth of nations? Measuring Capital for the 21st Century* states that "rich countries are largely rich because of the skills of their populations and the quality of the institutions supporting economic activity." This intangible capital the book argues – that is, "the human capital and the value of institutions (as measured by rule of law) – constitutes the greatest form of wealth in virtually all countries." Critical to this intangible capital is "the trust among people in a society and their ability to work together for a common purpose".

It is within this context that the ATO seeks to add value to our nation, including a reduction in compliance costs and the regulatory burden.

The initiatives outlined in our *Making it easier to comply 2007-08* booklet are part of the ATO's commitment to be an institution that delivers on its direct charter and does so in a way that develops trust and a common purpose.

Thank you.

²⁴ The Commissioner of Taxation has a separate statutory role as the Registrar of the Australian Business Register.

SOME PERSPECTIVES FROM THE UNITED STATES ON THE WORLDWIDE TAXATION VS. TERRITORIAL TAXATION DEBATE*

J. CLIFTON FLEMING, JR.,** ROBERT J. PERONI,*** AND
STEPHEN E. SHAY****

I INTRODUCTION

Worldwide taxation and territorial taxation are the major alternatives by which a country (the “residence country”) can levy on its residents’ foreign income (“foreign-source income”).¹ In a true worldwide system, a residence country imposes its regular income tax on its residents’ entire foreign-source income at the time the income is earned.² Of course, that same income is also taxed by the foreign country where it originated (the “source country”).³ To relieve the resulting double burden, the residence country credits the source country tax against the residence country tax (the “foreign tax credit”).⁴ But if credits were allowed for foreign taxes in excess of the residence country tax on foreign-source income, the excess foreign taxes would effectively reduce the residence country tax on residence country domestic income. This would go beyond what is required to eliminate double taxation and would

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¹ See Charles H. Gustafson, Robert J. Peroni and Richard Crawford Pugh, *Taxation of International Transactions* (3d ed, 2006) 19-21. See also, Brian J. Arnold and Michael J. McIntyre, *International Tax Primer* (2d ed, 2002) 15, 30-47.

² See United States Treasury Department, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (2007) 55 <http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf> (hereinafter U.S. Treas. Dep’t, *Approaches*); J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, ‘Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income’ (2001) 5 *Florida Tax Review* 299, 339-340 <<http://ssrn.com/abstract=1022099>> (hereinafter Fleming, Peroni and Shay, *Fairness*).

³ See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation* (2d ed, 2004) 345; Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, ‘The David R. Tillinghast Lecture: “What’s Source Got to Do with It?” Source Rules and U.S. International Taxation’ (2002) 56 *Tax Law Review* 81, 83-106.

⁴ See Gustafson, Peroni and Pugh, above n 1, 19-20.

effectively subsidize the activity that produced the foreign-source income.⁵ To prevent the domestic tax base from being eroded by credits for source country taxes in excess of the residence country tax and to confine the foreign tax credit to the alleviation of international double taxation, the residence country usually limits its foreign tax credit to the amount of residence country tax on foreign-source income.⁶ If, however, the source country is a low-tax jurisdiction in comparison to the residence country, a worldwide system allows the residence country to collect a “residual tax” equal to the amount by which the residence country tax exceeds the source country tax.⁷

By contrast, under a pure territorial or exemption system, the residence country imposes no tax on its residents’ foreign-source business income. This is usually accomplished by allowing corporate residents an exemption for both foreign branch income and for dividends received from foreign corporations in which a corporate resident owns a substantial stock interest (often referred to as non-portfolio dividends).⁸ Thus, in a conventional territorial system, foreign-source business income bears only the source country tax.

In the real world, no country operates either a pure worldwide system or a pure exemption system. For example, worldwide countries generally permit residence tax on the foreign-source active business income of foreign corporations controlled by residents to be deferred until the income is repatriated.⁹ When the deferral period is lengthy, the effect is to substantially reduce the present value of the residence country tax, thereby narrowing the difference between a worldwide system and an exemption system.¹⁰ Likewise, exemption countries typically depart from a “pure” exemption

⁵ This would also shift the economic consequences of the high tax rate from the high tax source country to the residence country. See generally, Organization for Economic Cooperation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* (2007) 18, 99 (hereinafter OECD, *Tax Effects*) (“[F]oreign tax credit limitations are in order to avoid pure transfers of revenue.”); Harry Grubert and John Mutti, ‘Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?’, (1995) 2 *International Tax and Public Finance* 439, 441 (hereinafter Grubert and Mutti, *Taxing Multinationals*) (“Even a government with a cosmopolitan perspective cannot be indifferent to the ... incentives provided to other governments to divert revenue to their own coffers.”); Harry Grubert and Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income* (2006) 8 Rutgers University <<http://econweb.rutgers.edu/altshule/research/200626.pdf>> at 25 October 2008 (hereinafter Grubert and Altshuler, *Corporate Taxes*) (“[The justification for the credit limitation has to do with the behavior of governments and not the behavior...of taxpayers.”).

⁶ See Staff of Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment*, JCX-55-08 (2008) 6 <<http://www.house.gov/jct/x-55-08.pdf>> (hereinafter Joint Comm., *Alternative U.S. Tax Policies*); Gustafson, Peroni and Pugh, above n 1, 20, 277; Ault and Arnold, above n 3, 362.

⁷ See Gustafson, Peroni and Pugh, above n 1, 20, 280.

⁸ See Ault and Arnold, above n 3, 372-73.

⁹ See Staff of Joint Committee on Taxation, *Present Law and Background Related to Selected Business Tax Issues*, JCX-41-06 (2006) 55 <<http://www.house.gov/jct/x-41-06.pdf>> (hereinafter Joint Comm., *Business Tax Background*); Ault and Arnold, above n 3, 377. This feature of worldwide systems is sometimes referred to as the deferral privilege or the deferral principle.

¹⁰ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 16 n. 41; J. Clifton Fleming, Jr. and Robert J. Peroni, ‘Reinvigorating Tax Expenditure Analysis and Its International Dimension’ (2008) 27 *Virginia Tax Review* 437, 529-30, 547-50 <<http://ssrn.com/abstract=1119326>> (hereinafter Fleming and Peroni, *Tax Expenditure Analysis*); Staff of Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06 (2006) 32-46 <<http://www.house.gov/jct/x-22-06.pdf>> (hereinafter Joint Comm., *Competitiveness Background*); Staff of Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (2005) 189

model by imposing worldwide taxation on all foreign-source income of non-corporate residents and on foreign-source passive income of corporate residents (except for non-portfolio dividends), thus bringing real-world exemption systems closer to “non-pure” worldwide systems.¹¹ Accordingly, when commentators label countries as worldwide or exemption (territorial) countries, it should be understood that the commentators are referring to the predominant characteristics of those countries’ respective international tax systems and are not suggesting that those countries have adopted the pure or ideal form of the system attributed to them. Indeed it is more accurate to characterize a worldwide system with deferral as a “hybrid worldwide” system and to describe exemption (territorial) systems that require worldwide treatment for certain kinds of income and taxpayers as “hybrid exemption” systems.¹²

In recent years, there has been a movement towards hybrid exemption systems.¹³ Indeed, they are now employed by more than half of the OECD member countries¹⁴ and the OECD recently recommended that the United Kingdom adopt such a system.¹⁵

The United States approach to taxing foreign-source income is a hybrid worldwide system in form. However, because of deferral of U.S. tax on foreign-source active business income, liberal cross crediting opportunities and other defects, the U.S. system can actually produce a better-than-exemption result in the form of a negative rate of U.S. tax on foreign-source income.¹⁶ Moreover, the current U.S. system involves more complexity than the typical hybrid exemption system without achieving a dramatically greater revenue yield.¹⁷

<<http://www.house.gov/jct/s-2-05.pdf>> (hereinafter Joint Comm., *Options*); Harry Grubert and T. Scott Newlon, ‘The International Implications of Consumption Tax Proposals’ (1995) 48 *National Tax Journal* 619, 626 .

¹¹ See Joint Comm., *Options*, above n 10, 187; Ault and Arnold, above n 3, 357-60; Commission of the European Communities, *Dividend Taxation of Individuals in the Internal Market*, COM (2003) 810 final (2003) 19

<<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0810:FIN:EN:PDF>>; Grubert and Newlon, above n 10, 623. See also T. Timothy Tuerff, Daniel Shaviro, Douglas A. Shackelford, Timothy M. McDonald and Michael Mundaca, ‘Session 4: Alternatives for Taxation of Foreign Source Income’, (June 2008) 86 *Taxes* 71, 76 (suggesting that if an income tax regime applies progressive rates to individuals, the tax base for individuals subject to the regime should be their worldwide incomes).

¹² See Joint Comm., *Options*, above n 10, 186-87; Ault and Arnold, above n 3, 358-60.

¹³ See U.S. Treas. Dep’t, *Approaches*, above n 2, 54, 57.

¹⁴ See OECD, *Tax Effects*, above n 5, 19, 104-05; U.S. Treas. Dep’t, *Approaches*, above n 2, 57.

¹⁵ See Charles Gnaedinger, ‘OECD Recommends Corporate Tax Changes for U.K.’, (2007) 48 *Tax Notes International* 151. With respect to earlier discussions regarding a U.K. territorial system, See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 46-48.

¹⁶ See J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, ‘Better Than Exemption’ (forthcoming) (hereinafter cited as Fleming, Peroni and Shay, *Better*); U.S. Treas. Dep’t, *Approaches*, above n 2, 57; Joint Comm., *Options*, above n 10, 188-89. When excess foreign tax credits on high-taxed foreign-source income are cross-credited against U.S. residual tax on low-taxed foreign-source income, the U.S. tax saving is effectively a negative U.S. tax on the high-taxed foreign-source income. Likewise, if expenses that have an economic nexus with high-taxed foreign income are deducted against U.S. domestic income, the U.S. tax saving is effectively a negative U.S. tax on the high-taxed foreign source income. Because of its defects, the U.S. international income tax system can be roughly described as more generous than a territorial system with respect to the foreign-source business income of U.S. resident corporations and as a worldwide system with respect to all other foreign-source income received by U.S. residents.

¹⁷ See U.S. Treas. Dep’t, *Approaches*, above n 2, 57 (“U.S. tax on all corporate foreign income was about \$18.4 billion in 2004”).

These shortcomings of the U.S. system plus the movement of other developed countries towards hybrid exemption systems has led to serious suggestions that the United States should adopt a hybrid exemption system.¹⁸ Most observers agree that the present U.S. hybrid worldwide system is, indeed, unacceptable and requires major reform.¹⁹ Beyond that point of agreement a pair, however, of debates has emerged. Although these two debates are distinguishable and have quite different answers, there is an erroneous tendency to believe that the solution to the first also dictates the outcome of the second. We strongly disagree.

The first of these debates focuses on the question of whether a well-designed hybrid exemption system is superior to the present U.S. hybrid worldwide system. As explained below, we believe that a well-designed hybrid exemption system is preferable to the defective regime presently employed by the United States. This is a spurious and distracting discussion, however, because there is no need for the U.S. system to be so poorly designed. Therefore, it is inappropriate to use the highly compromised U.S. approach as the point of comparison in the argument over whether the United States should adopt a theoretically correct exemption regime.²⁰

The second debate is the appropriate controversy. It centers on whether a well-designed hybrid exemption system is superior to a well-designed worldwide system that would differ importantly from the seriously flawed hybrid regime currently being operated by the United States. We conclude that a properly constructed worldwide system is preferable to a well-designed exemption regime.

II A SPURIOUS DEBATE: TERRITORIALITY V. PRESENT U.S. SYSTEM

A correctly framed territorial (exemption) system would exempt only foreign-source income, would ensure that foreign expenses and losses are not deductible

¹⁸ The U.S. Treasury Department has recently described the virtues of a territorial system in terms that amount to a recommendation for replacing the current U.S. regime with a territorial system. See U.S. Treas. Dep't, *Approaches*, above n 2, 54-63; For details of the major U.S. exemption system proposals, see Joint Comm., *Options*, above n 10 186-97; President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* (2005) 132-35 (hereinafter Advisory Panel, *Proposals*). For critiques of these proposals, See J. Clifton Fleming Jr. and Robert J. Peroni, 'Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System' (2005) 109 *Tax Notes* 1557 <<http://ssrn.com/abstract=870539>> (hereinafter Fleming and Peroni, *Exploring*); Paul R. McDaniel, 'Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?' (2007) 8 *Florida Tax Review* 283; Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn van Kessel, 'Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience' (2006) 111 *Tax Notes* 799; James R. Repetti, 'Will U.S. Investments Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform' (2007) 8 *Florida Tax Review* 303.

¹⁹ See 'Report of the Task Force on International Tax Reform, ABA Tax Sec.' (2006) 59 *Tax Lawyer* 649, 717-18 (hereinafter Tax Sec. Report); Joint Comm., *Options*, above n 10, 188-89; George K. Yin, 'Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers' (2008) 118 *Tax Notes* 173 (hereinafter Yin, *Reforming*).

²⁰ If the current U.S. worldwide system could not be made substantially more consistent with a well-designed worldwide system than it presently is, then it would make sense to compare the flawed U.S. System with an ideal territorial system. This is not the case, however. With respect to feasible steps for bringing the U.S. system in line with a well-designed worldwide system, See Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, 'Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income' (1999) 52 *Southern Methodist University Law Review* 455 <<http://ssrn.com/abstract=1096262>> (hereinafter, Peroni, Fleming and Shay, *Getting Serious*); Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, 'Reform and Simplification of the Foreign Tax Credit Rules' (2003) 101 *Tax Notes* 103 (hereinafter Peroni, Fleming and Shay, *Reform*).

against domestic income and would tax foreign-source interest, royalties and service fees paid by foreign subsidiaries and branches.²¹ Thus, structurally sound territorial systems require properly designed source rules, expense allocation rules and robust transfer pricing rules. Moreover, because a principal purpose for adopting a territorial system instead of a worldwide system is to make companies resident in the adopting country competitive with companies resident in exemption system countries,²² a well-designed exemption system would be no more generous than the systems of other countries. Consequently, it would follow the pattern established in other exemption system countries of preserving worldwide taxation with respect to all foreign-source income of non-corporate residents and foreign-source passive income of corporate residents.²³ This would require foreign tax credit rules for income and taxpayers that are excluded from exemption treatment and rules to distinguish included and excluded income and taxpayers. As a result, well-designed territorial systems are not simple.²⁴ They are, however, modestly simpler than worldwide systems including the present U.S. international income tax regime. Moreover, because of (1) defective cost allocation rules,²⁵ (2) aggressive transfer pricing,²⁶ (3) the deferral privilege,²⁷ (4) a

²¹ Royalties and service fees are typically treated by foreign countries as deductible expenses that bear no foreign tax. See U.S. Treas. Dep't, *Approaches*, above n 2, 58, 62; Joint Comm., *Options*, above n 10, 189-95. Because the purpose of an exemption system is to alleviate double taxation, there is no reason to grant exemption to items that bear no foreign tax and it is no surprise that exemption treatment systems typically tax royalties and service fees. In addition, royalties are often a return on research and development costs incurred in the residence country and, to that extent, they are not properly classified as foreign-source income. See generally, Grubert and Mutti, *Taxing Multinationals*, above n 5, 450-51. See also, Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 38 (discussing a "subject to foreign tax" requirement).

²² See eg, Grubert and Mutti, *Taxing Multinationals*, above n 5, 441.

²³ See Joint Comm., *Options*, above n 10, 189; Ault and Arnold, above n 3, 372-75.

²⁴ See Fleming and Peroni, *Exploring*, above n 18, 1560-68.

²⁵ See generally, Harry Grubert, 'Enacting Dividend Exemption and Tax Revenue', (2001) 54 *National Tax Journal* 811.

²⁶ See OECD, *Tax Effects*, above n 5, 112 ("Business claims that income that has been irregularly shifted offshore can be taxed by properly applying transfer pricing rules and principles... [This] argument assumes that tax authorities will be able in each instance to ensure that prices applied in related-party transactions result in offshore profits that are not in excess of amounts that would arise from transactions between unrelated parties operating at arm's length. For many transactions, in particular those that involve intangibles, the task is very difficult and may be impossible to ensure in many cases, even assuming available resources to audit all related-party transactions."); Lee A. Sheppard, 'Treasury Officials Discuss Reform, Contract Manufacturing' (2008) 118 *Tax Notes* 1083, 1084 ("Transfer pricing is dead Despite everyone's efforts, we're not collecting tax." Quoting Edward D. Kleinbard, Chief of Staff of the Joint Committee on Taxation of the U.S. Congress); Martin A. Sullivan, 'Democratic Senators Eye Offshore Profits' (2006) 110 *Tax Notes* 590, 591 ("Methods consistent with the arm's-length method (as interpreted by the private-sector consultants) yield an enormous range of defensible results. Because there is a wide range of possible outcomes, the victories in transfer pricing battles go to the party with the most economic and legal firepower. That's almost always the corporation, not the IRS."); Tax Sec. Report, above n 19, 703 ("Even with small price adjustments, the aggregate amount of income that may be shifted within the range allowable under the regulations (and the amount of tax saved) can be material."). See also, J. Clifton Fleming Jr., Robert J. Peroni and Stephen E. Shay, 'An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral' (2000) 20 *Tax Notes International* 547 (hereinafter Fleming, Peroni, and Shay, *Deferral*); Martin A. Sullivan, 'U.S. Multinationals Shifting Profits Out of the United States' (2008) 118 *Tax Notes* 1078 (hereinafter Sullivan, *Shifting*); Martin A Sullivan, 'The IRS Multibillion-Dollar Subsidy for Ireland', (2005) 108 *Tax Notes* 287.

²⁷ See Peroni, Fleming and Shay, *Getting Serious*, above n 20, 458-470.

two-basket foreign tax credit limitation that facilitates extensive cross-crediting²⁸ and (5) the deductibility of overall foreign losses against domestic income,²⁹ the current U.S. international taxation system can be more generous than a well-designed exemption system.³⁰ Indeed, the U.S. regime can be manipulated to produce a negative U.S. tax on foreign-source income.³¹ For these reasons, if the question is whether the current U.S. international income tax system should be replaced with a well-designed territorial approach, we believe the answer is that replacement should occur.

This is, however, the correct answer to the wrong question. Because present defects can be cured,³² the appropriate inquiry is how well does a *well-designed* worldwide system measure up against a well-designed exemption regime.³³ We address that debate in part III.

III THE APPROPRIATE DEBATE: TERRITORIALITY V. A WELL-DESIGNED WORLDWIDE SYSTEM

A Describing a Properly Designed Worldwide System

A properly designed worldwide system would tax foreign-source income as it is earned (i.e. there would be no deferral) so that (1) the distortive bias in favor of locating business activity in low-tax foreign jurisdictions would be eliminated,³⁴ (2) the repatriation tax barrier would be removed³⁵ and (3) the incentive to engage in aggressive transfer pricing with respect to outbound activity would be substantially reduced.³⁶ Such a system would also have a foreign tax credit limitation that curtailed

²⁸ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 8; Gustafson, Peroni and Pugh, above n 1, 602-03; J. Clifton Fleming, Jr. and Robert J. Peroni, 'Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax – What's ETI Repeal Got to Do with It?' (2004) 104 *Tax Notes* 1393, 1394, 1403-05 (hereinafter Fleming and Peroni, *Eviscerating*).

²⁹ See Gustafson, Peroni and Pugh, above n 1, 615-17.

³⁰ See Joint Comm., *Options*, above n 10, 188-89; Lawrence Lokken, 'Does the U.S. Tax System Disadvantage U.S. Multinationals in the World Marketplace?' (Summer 2004) 4 *Journal of the Taxation of Global Transactions* 43.

³¹ See Fleming, Peroni and Shay, *Better*, above n 16; Lawrence Lokken, 'Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)' (2006) 59 *Southern Methodist University Law Review* 751, 759-70 (hereinafter Lokken, *Territorial Taxation*). This state of affairs has led to the argument that because the current U.S. system can yield better-than-exemption results, the United States should abandon the pretense of worldwide taxation and adopt an explicit territorial system with respect to foreign-source income. See Robert Goulder, 'If in Doubt, Blame Check the Box' (2008) 119 *Tax Notes* 1061, 1063. As explained at below n 46, we disagree.

³² See authorities cited in below n 46.

³³ See Lokken, *Territorial Taxation*, above n 31, 771. See also, Randall Jackson, 'Support for Territorial Tax Regime Growing, Panelists Say' (2008) 118 *Tax Notes* 899 ('[A]cademics have come to view a middle position between the two poles of worldwide and territorial-based taxation as weaker than a position at one of the two poles.') For an example of an appropriate framing of the inquiry, although it differs somewhat from the structure used in this article, see Joint Comm. *Alternative U.S. Tax Policies*, above n 6.

³⁴ See Gustafson, Peroni and Pugh, above n 1, 17-20, 277-78; Grubert and Newlon, above n 10, 624-25.

³⁵ See Fleming and Peroni, *Eviscerating*, above n 28, 1413-14.

³⁶ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 14; Peroni, Fleming and Shay, *Getting Serious*, above n 20, 512, 514.

cross-crediting,³⁷ expense allocation rules that prevented foreign losses and expenses from being deducted against domestic-source income³⁸ and source rules that prevented domestic-source income from being misclassified as foreign-source income.³⁹ The present U.S. worldwide system is deficient on all these points. Specifically, it permits deferral of tax on foreign-source income until repatriation,⁴⁰ subject to only feeble limitations.⁴¹ Moreover, it has a two-basket foreign tax credit limitation (a passive income basket with look through rules and an active income basket) that allows substantial cross-crediting.⁴² It also permits certain foreign expenses and losses to be deducted against domestic-source income.⁴³ Finally, it employs rules for sourcing income that misclassify certain U.S.-source income as foreign-source income.⁴⁴

As noted above, a worldwide system burdened with these deficiencies receives a failing grade when compared with a well-designed exemption or territorial system.⁴⁵ But a worldwide system need not be so imperfect. Proper design is feasible⁴⁶ and if a worldwide system is structurally sound, then we believe it is superior to an exemption system.

B *Economic Doctrines*

Among economists, the worldwide taxation vs. territorial taxation debate has been principally a dispute regarding the strengths and weaknesses of three economic doctrines: capital export neutrality, which is associated with worldwide taxation, and capital import neutrality and capital ownership neutrality, both of which are linked to territorial taxation.⁴⁷ In this article, we do not delve into the controversy regarding the

³⁷ See Peroni, Fleming and Shay, Reform, above n 20, 110; Fleming and Peroni, Eviscerating, above n 28, 1394, 1403-05; authorities cited in above n 5, above n; see also Grubert and Newlon, above n 10, 626.

³⁸ See Gustafson, Peroni and Pugh, above n 1, 118; Arnold and McIntyre, above n 1, 48-50.

³⁹ See Peroni, Fleming and Shay, Reform, above n 20, 132.

⁴⁰ See Peroni, Fleming and Shay, Getting Serious, above n 20, 459-60. See also, Grubert and Newlon, above n 10, 626 (“One feature pushing the U.S. system...[in the direction of exemptions or territorial taxation] is deferral, which can substantially reduce the present value of U.S. tax on the income of foreign subsidiaries of U.S. companies”).

⁴¹ See Peroni, Fleming and Shay, Getting Serious, above n 20, 460-64.

⁴² See Tax Sec. Report, above n 19, 694. Until 2007, the United States attempted to curtail cross-crediting by assigning foreign-source income to eight separate baskets for foreign tax credit purposes. See Gustafson, Peroni & Pugh, above n 1, 602-14. Nevertheless, extensive cross-crediting occurred because most income involved in foreign tax credit computations fell into a single basket, the so-called general limitation basket. For example, in 2004, 73.4% of the foreign-source income involved in U.S. foreign tax credit computations was general limitation basket income. See Scott Luttrell, ‘Corporate Foreign Tax Credit, 2004’ (2008) 28 *SOI Bulletin* No. 1 at 111 <<http://www.irs.gov/pub/irs-soi/04cofortxcr.pdf>>. The two-basket system that applies after 2006 allows even more extensive cross-crediting.

⁴³ See Fleming, Peroni and Shay, Better, above n 16.

⁴⁴ See Peroni, Fleming and Shay, Reform, above n 20, 132; Grubert and Mutti, Taxing Multinationals, above n 5, 450-51.

⁴⁵ See text, accompanying above n 25-31.

⁴⁶ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 50-63; Tax Sec. Report, above n 19, 731-35; Peroni, Fleming and Shay, Reform, above n 20; Peroni, Fleming and Shay, Getting Serious, above n 20, 507-23.

⁴⁷ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 12-13; OECD, *Tax Effects*, above n 5, 96-101; Joint Comm., *Competitiveness Background*, above n 10, 3, 5; Joint Comm., *Business Tax Background*, above n 9, 55-56; Grubert and Altshuler, *Corporate Taxes*, above n 5, 3; Arnold and McIntyre, above n 1, 5-6; United States Treasury Department, *The Deferral of Income Earned Through*

comparative merits of these three economic theories because the debate is unresolved⁴⁸ and all three doctrines have deficiencies that make them inadequate as organizing principles for an international income tax regime.⁴⁹ Instead we focus on distortions and inequities that policy makers should seek to avoid, or at least minimize when constructing an international income tax system, regardless of the theoretical strengths and weaknesses of capital export neutrality, capital import neutrality and capital ownership neutrality.⁵⁰

C Inefficient Distortions

In choosing between worldwide and territorial taxation, policy makers should be aware that both regimes have the capacity to create important and inefficient behavioral distortions. As explained below, however, we believe that these distortions are significantly less problematic under the worldwide approach than under territorial taxation and that a properly designed worldwide system should be preferred on that ground alone.⁵¹

1 Tax Haven Finance Subsidiary

For an example of the distortiveness inherent in territorial systems, assume that Parentco is a resident of an exemption system country, that Parentco has a wholly owned Country A active-business subsidiary that pays a 40 percent Country A tax on its profits (calculated with a deduction for interest payments) and that tax haven Country B, which has a 10 percent corporate income tax and no withholding taxes, is available to facilitate tax planning. In a no-tax world, Parentco would simply cause the Country A subsidiary to periodically remit its profits as dividend distributions. Given the preceding facts, however, Parentco will have a strong incentive to undercapitalize the Country A subsidiary and to organize and capitalize a Country B finance subsidiary that will make interest-bearing loans to the Country A subsidiary. The Country B subsidiary will then periodically transfer its interest receipts to Parentco as exempt dividends. Under this arrangement, all income of the Country A subsidiary that is paid as interest to the Country B subsidiary will move from the 40 percent Country A tax to the 10 percent Country B tax. This saving of 30 percentage points will be a powerful inducement for Parentco to incur the costs of establishing

U.S. Controlled Foreign Corporations (2000) 26-42 <<http://www.treas.gov/offices/tax-policy/library/subpartf.pdf>> (hereinafter U.S. Treas. Dep't, *Deferral*); Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54 *Tax Law Review* 261, 270-71 (hereinafter Graetz, *Outdated Concepts*).

⁴⁸ See Fleming, Peroni and Shay, *Fairness*, above n 2, 308 n. 14.

⁴⁹ See United States Treasury Department, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* (2007) 48-49 <<http://www.treas.gov/press/releases/reports/07230%20r.pdf>> (hereinafter U.S. Treas. Dep't, *Background Paper*); Grubert and Altshuler, *Corporate Taxes*, above n 5, 3, 16-18; Graetz, *Outdated Concepts*, above n 47, 276-99. In our judgment, however, the doctrine of capital export neutrality comes closest to being the correct organizing principle and serves as a useful guide, notwithstanding its deficiencies.

⁵⁰ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 18 (“[W]hat reform within an income tax can hope to accomplish is to eliminate unnecessary waste and the possibility of extremely high or low tax burdens that are not justified under any standard. Then we can at least be sure that we are moving toward the optimum without overshooting it and running the risk of making things worse.”).

⁵¹ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 4.

and operating the Country B subsidiary even if doing so would be senseless in a no-tax world.⁵² This distortion, which benefits only the professionals engaged in document creation and follow-up legal compliance with respect to tax haven finance subsidiaries, could be reduced if Parentco's residence country adopted a controlled foreign corporation regime that caused Parentco to pay a current tax on the interest received by the Country B subsidiary from the Country A subsidiary. However, given that this measure would not completely eliminate the distortive incentive⁵³ and that Parentco's home country policy makers were willing to let Parentco directly receive the Country A subsidiary's profits without paying home country tax, the home country might not choose to impose a tax on Country A profits routed through the Country B subsidiary.⁵⁴ If that were the case, the distortive force of the home country exemption system would remain fully in place. And if Parentco's home country did adopt a measure that imposed tax on dividends received from the Country B finance subsidiary, this would add a layer of complexity to the home country exemption system.

By contrast, these issues are substantially less important in a well-designed worldwide system in which the income of the low-taxed subsidiary bears a residual tax equal to the excess of the parent corporation's home country tax over the tax in the low-tax country.⁵⁵ Thus, transforming income of a high-taxed subsidiary into interest receipts of a low-taxed subsidiary accomplishes nothing except to the extent that the levy in the high tax country exceeds the tax rate in the parent corporation's home country⁵⁶ or except where the parent corporation has sufficient credits from other high-taxed income to eliminate the residual tax on the dividends received from the low-taxed subsidiary.⁵⁷ In the latter case, an effective barrier to cross crediting, such as a per-country foreign tax credit limitation, would protect the residual tax.⁵⁸ On balance, therefore, a worldwide system is somewhat less distortive than a territorial system with respect to the tax haven finance subsidiary strategy described above.

2 Aggressive Transfer Pricing

A second potential distortion that must be considered when choosing between worldwide and territorial taxation is income shifting through aggressive transfer pricing. To be specific, a territorial system inherently encourages a parent company to undercharge for goods, services and loan funds supplied to low-taxed foreign subsidiaries and to overpay such subsidiaries for the use of intangibles that were transferred to, or developed by the subsidiary.⁵⁹ These tactics shift income from the parent corporation to the foreign subsidiary, thereby causing the income to morph

⁵² See generally, *ibid* 28; OECD, *Tax Effects*, above n 5, 101, 113.

⁵³ On the facts of the example, this measure would result in reducing the tax burden on the shifted income from 40% to 30% (10% Country B tax plus 20% home country residual tax). Thus, the finance subsidiary strategy would continue to produce a tax saving.

⁵⁴ See Ault and Arnold, above n 3, 372-73.

⁵⁵ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 28.

⁵⁶ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 34-35. In the example in the text, if Parentco's residence country operated a well-designed worldwide system, imposed a 30% tax on corporate profits and limited its foreign tax credit to the 30% domestic tax, the Country A subsidiary's income would bear a full 40% Country A tax but the tax burden would fall to 30% with respect to income paid as deductible interest to the Country B subsidiary.

⁵⁷ See *ibid* 35.

⁵⁸ See Peroni, Fleming and Shay, *Reform*, above n 20, 121-23.

⁵⁹ See Yin, *Reforming*, above n 19, 175; Grubert and Altshuler, *Corporate Taxes*, above n 5, 24, 33.

from domestic income taxable at the parent's marginal rate into foreign-source income that bears only the low foreign tax imposed by the subsidiary's residence country. This erodes the tax base of the parent corporation's residence country and causes parent-subsidiary transactions to be structured in ways that would not occur in the absence of tax considerations.

This distortion can be combated only if the parent corporation's residence country is willing to adopt rigorous transfer pricing rules and then fund an effective administration of those rules.⁶⁰ These steps, however, will inevitably produce a significant level of conflict between taxpayers and the revenue service. By contrast, the current home country residual tax imposed on the income of foreign subsidiaries under a properly designed worldwide system eliminates the advantage of using aggressive transfer pricing to shift income to low-tax foreign subsidiaries except where the parent corporation has excess foreign tax credits that can be used to absorb the home country residual tax on the shifted income.⁶¹ However, this is a less significant income shifting problem than exists under a territorial regime and it can be combated with a per-country foreign tax credit limitation⁶² or a rigorous basket approach that separates high- and low-taxed income for foreign tax credit purposes.⁶³ At the end of the day, the potential for distortion on this margin seems substantially smaller under a well-designed worldwide system than under a territorial system.

3 Transforming Interest and Royalties Into Exempt Dividends

A closely-related form of distortion arises from the fact that royalty payments and interest payments from a foreign subsidiary to its parent are taxable income for the parent under an archetypical territorial system whereas dividend distributions from the subsidiary to the parent are exempt income under such a system.⁶⁴ This creates an incentive for parent corporations to minimize taxable interest and royalty income by undercharging foreign subsidiaries for loans and the use of intangibles and then to recapture the undercharges through exempt dividends from the subsidiaries.⁶⁵ Combating this tactic requires rigorous transfer pricing rules and vigilant enforcement that leads to complexity and controversy. By contrast, under a well-designed worldwide system, dividends from a subsidiary are also exempt income⁶⁶ but a parent corporation is taxed on its foreign subsidiary's net income as it accrues so that the dividend exemption does not avoid tax in the parent's home country.⁶⁷ Thus, interest and royalty undercharges to the subsidiary by the parent merely give the subsidiary a larger net income on which the parent pays a larger current tax. This means that there is no tax advantage under a well-designed worldwide system from converting royalty and interest payments into exempt dividends and this distortive incentive, which is an inherent feature of a territorial system, is absent from a worldwide system. Thus, a well-designed worldwide system is less distortive along this margin than an exemption system.

⁶⁰ See OECD, *Tax Effects*, above n 5, 112.

⁶¹ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 14, 24, 34-35.

⁶² See Peroni, Fleming and Shay, *Reform*, above n 20, 121-23.

⁶³ See *ibid* 118-19.

⁶⁴ See Joint Comm., *Options* above n 10, 187; Ault and Arnold, above n 3, 357-60.

⁶⁵ See Grubert and Altshuler, *Corporate Taxes*, above n 5, 33.

⁶⁶ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 50-54.

⁶⁷ See *ibid* 50-54.

4 Location Distortion

(a) Pretax vs. Post Tax Returns

Although the preceding distortions are important to the choice between a well-designed worldwide system and an exemption or territorial system, we believe that the principal efficiency reason for preferring the worldwide approach is that exemption systems distort business location decisions. To be specific, taxpayers operating under exemption systems are encouraged to invest capital in low-tax foreign countries instead of in their residence country or in high-tax foreign countries, even if the pretax return from the low-tax country investment is inferior to the pretax return from an investment in the residence country or in a high-tax foreign country.⁶⁸ Consider the following example:

Example 1. U.S. Multinational Inc. (USM) is a U.S. domestic corporation with skilled management and valuable intangibles that can be applied abroad. It pays U.S. tax on its U.S.-source income at a rate of 35 percent but assuming that the United States has adopted an exemption system, there is no U.S. tax on USM's foreign-source income. The assets of a business that earns only foreign-source income are for sale in Country X, a wonderful tax haven that has no tax on corporate profits and no withholding tax regime. A business is also for sale in the United States. USM can earn a 20 percent before-tax return on capital invested in the U.S. business and a 15 percent before-tax return if it invests capital in the Country X business.

Given those facts, USM would prefer the Country X investment to the U.S. investment even though the latter is economically superior to the Country X investment. That is because USM's 20 percent before-tax return from investing in the U.S. business would be reduced to 13 percent by the 35 percent U.S. tax on domestic-source income,⁶⁹ while the U.S. exemption system for foreign-source income would provide USM a 15 percent return on its investment in the Country X business. Thus, the exemption system would cause USM to forgo the economically superior purchase of the U.S. business in favor of the economically inferior acquisition of the Country X

⁶⁸ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 26; Robert J. Peroni, 'Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules' (1997) 51 *University of Miami Law Review* 975, 983 (hereinafter Peroni, Back to the Future); Robert J. Peroni, 'Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle With Subpart F?' (2001) 79 *Texas Law Review* 1609 (hereinafter Peroni, End It); See also Jane G. Gravelle, 'Foreign Tax Provisions of the American Jobs Act of 1996' (1996) 13 *Tax Notes International* 763. But see Terrence R. Chorvat, 'Ending the Taxation of Foreign Business Income' (2000) 42 *Arizona Law Review* 835, 841-845.

The magnitude of this distortion is quite significant. See Harry Grubert and John Mutti, 'Do Taxes Influence Where U.S. Corporations Invest?' (2000) 53 *National Tax Journal* 825 (hereinafter Grubert and Mutti, Where U.S. Corporations Invest) (suggesting that almost one out of every five dollars invested abroad by U.S. corporations is drawn to its investment location because of low host country taxes); Donald J. Rousslang, 'Deferral and Optimal Taxation of International Investment Income' (2000) 53 *National Tax Journal* 589, 596; Sullivan, Shifting, above n 26; Martin A. Sullivan, 'U.S. Citizens Hide Hundreds of Billions in Cayman Accounts' (2004) 103 *Tax Notes* 956, 957 ("[F]rom 1993 through 2001, assets of non-financial subsidiaries of U.S. corporations grew from \$9 Billion to \$142 Billion.").

⁶⁹ $0.20 \times (1 - 0.35) = 0.13$.

business, an undesirable policy result.⁷⁰ By contrast, a U.S. worldwide system without deferral would impose a 35 percent tax on both the U.S. and Country X returns with the result that the 15 percent before-tax Country X return would be reduced to 9.75 percent and USM would choose the economically superior U.S. investment.⁷¹

(b) The Competitiveness Argument

Those who believe in hybrid exemption systems (i.e., that a zero rate of domestic tax on foreign-source active business income is the right result) rely principally on a competitiveness argument that can be stated as follows: local businesses in a low-tax foreign country pay only the low local income tax on their in-country profits. The same is true of foreign corporations operating in the low-tax country but resident in a country that exempts foreign-source income from residence country tax. Without exemption, companies resident in a worldwide country (residence country companies) would be unduly disadvantaged when competing in low-tax foreign countries because in addition to the low foreign tax, they would pay a current home country residual tax on their foreign profits while their local and exemption country competitors would pay only the low foreign tax. Therefore, so the argument goes, residence countries should exempt the foreign-source active business income of their resident companies.⁷²

This argument is not a request for the residence country to give double taxation relief that would otherwise be unavailable in a worldwide system. The necessary relief is provided in a worldwide system by means of the foreign tax credit. Instead,

⁷⁰ See Grubert and Mutti, *Taxing Multinationals*, above n 5, 443 (“[T]here is no a priori reason to increase the competitiveness of [foreign] affiliates at the expense of domestic production.”); Grubert and Newlon, above n 10, 624-25. In the U.S. context, both the Advisory Panel’s and the Joint Committee Staff’s recent exemption proposals attempt to minimize the significance of this point by invoking economic studies concluding that adoption of a U.S. exemption system would not cause a material movement of business from the United States to low-tax foreign countries. See Advisory Panel, *Proposals*, above n 18, 135; Joint Comm., *Options*, above n 10, 196. But those studies compare results under an exemption system with results under the current U.S. international tax system that can be even more distortive than a properly designed exemption system. Thus, those studies do not undermine the conclusion that when compared with a well-designed worldwide system, an exemption system significantly distorts the business location decision.

⁷¹ See generally, Grubert and Newlon, above n 10, 624-25.

⁷² See generally, OECD, *Tax Effects*, above n 5, 108-111; Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 29; Joint Comm., *Competitiveness Background*, above n 10, 56, 59; National Foreign Trade Council, *International Tax Policy for the 21st Century* (2001) vol 1, 12 (hereinafter NFTC, *International Tax Policy*); Grubert and Mutti, *Taxing Multinationals*, above n 5, 441; James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income* (2007) 32-33, <http://taxprof.typepad.com/taxprof_blog/files/hines_reconsidering_nov_07.pdf> at 25 October, 2008 (hereinafter Hines, *Reconsidering*); U.S. Treas. Dep’t, *Approaches*, above n 2, 46; Peter Mullins, ‘Moving to Territoriality? Implications for the U.S. and the Rest of the World’ (2006) 43 *Tax Notes International* 839, 844 (hereinafter Mullins, *Moving to Territoriality*). As explained at below n 255, VAT rebates on exports from countries that employ the VAT create the appearance of an export subsidy even though economists generally characterize this appearance as false. Nevertheless, because the U.S. does not employ a VAT, this appearance has created political momentum for a series of U.S. export subsidy regimes structured as income tax provisions that were said to be necessary for making U.S. exporters competitive with exporters resident in VAT countries. Each of these U.S. regimes has been held non-compliant with either GATT law or WTO law. Regarding this interesting episode in U.S. tax history, see Paul R. McDaniel, ‘The David R. Tillinast Lecture: Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions,’ (2004) 57 *Tax Law Review* 275; Paul R. McDaniel, ‘Trade and Taxation’ (2001) 26 *Brooklyn Journal of International Law* 1627, 1627-33.

the competitiveness argument is a request for tax system assistance that is not available to earners of income sourced in the residence country. This appeal for preferential treatment of foreign-source income should be closely scrutinized. In our judgment, such scrutiny reveals that, in the U.S. context at least, there is no persuasive case for relieving foreign-source active business income from residence country income tax.

To be specific, the argument by U.S. proponents of exemption proposals that adoption of an exemption system is necessary for U.S. multinationals to compete in the global marketplace is unsupported by empirical evidence that a competitiveness problem exists and that the proposed exemption system would solve the problem. Claims by exemption advocates that a competitiveness problem exists are rendered questionable at best by the extensive overseas success of many U.S. businesses.⁷³ Where is the proof (as contrasted with anecdotes and special pleading) of a systemic competitiveness problem⁷⁴ that is substantially caused by the U.S. international

⁷³ For a sample of sources regarding the successes of U.S. multinational corporations in foreign markets, see Matt Andrejczak and Donna Kardos, 'Heinz Earnings Rise by 7.2%, Helped by Higher Prices', *The Wall Street Journal* (New York City) May 30, 2008, B4; William M. Bulkeley, 'High-Margin Services Lift IBM', *The Wall Street Journal* (New York City) Oct. 17, 2008, B2; Russell Gold, 'Exxon to Boost Spending, Broaden Exploration', *The Wall Street Journal* (New York City) March 6, 2008, B1; Christopher Hinton, 'Monsanto Net Nearly Triples', *The Wall Street Journal* (New York City), Jan. 4, 2008, C14; Kathryn Kranhold, 'GE's Strength Abroad Helps It Weather Weakness in U.S.', *The Wall Street Journal* (New York City) Jan. 19-20, A3; Tom Lauricella, 'Economic Split Seen in Corporate Earnings', *The Wall Street Journal* (New York City) April 18, 2008, A1 (In the recession of 2008, U.S. businesses continue to perform well in foreign markets); Betsy McKay, 'Pepsi to Boost China Outlay by \$1 Billion', *The Wall Street Journal* (New York City) Nov. 4, 2008, B3; Betsy McKay, 'Coke Net Rises 19%, Aided by Weak Dollar', *The Wall Street Journal* (New York City) April 17, 2008, B3; Betsy McKay & Anjali Cordeiro, 'Coke Overcomes Weak U.S. Results', *The Wall Street Journal* (New York City), Oct. 16, 2008, B3; Shira Ovide, 'P&G Profit Rises 33%; Costs Hit Outlook', *The Wall Street Journal* (New York City) Aug. 6, 2008, B3.

⁷⁴ See U.S. Treas. Dep't., *Deferral*, above n 47 56, ("[T]he United States, as a general matter, is agreed upon by almost any measure to be one of the most competitive countries in the world."), 57; Martin A. Sullivan, 'Tax Incentives and Economists', (2006) 111 *Tax Notes* 20, 23-25; Timothy Aepfel, 'Overseas Profits Help U.S. Firms Through Tumult', *The Wall Street Journal* (New York City) Aug. 9, 2007, 1 (U.S. companies continue to experience growth in foreign-source profits); 'U.S. Again Holds No. 1 Rank in Competitiveness Survey', *The Wall Street Journal* (New York City) Oct. 9, 2008 A8 (2008 World Economic Forum Report ranks U.S. economy as most competitive in the world); Marc Champion, 'U.S. Ranked Most Competitive; Oil-Rich Nations Show Promise', *The Wall Street Journal* (New York City) Nov. 1, 2007, A4 (2007 World Economic Forum report characterized the U.S. economy as the most competitive in the world); World Economic Forum, *The Global Competitiveness Report 2005-2006, Executive Summary* (2006) 3 World Economic Forum http://www.weforum.org/pdf/Gcr/GCR_05_06_Executive_Summary.pdf at 25 October 2008 (finding that the United States had the world's second most competitive economy in 2005 because of "continuing technological supremacy, and a pipeline of innovation second to none in the world"). See also Mitchell A. Kane, 'Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks', (2006) 20 *Virginia Tax Review* 53, 64-65; Richard C. Pugh, 'The Deferral Principle and U.S. Investment in Developing Countries', in Robert Hellowell (ed) *United States Taxation and Developing Countries* (1980) 267, 280 (stating that "one faces a relative scarcity of detailed empirical analysis" in assessing the claims of advocates and opponents of deferral). But compare Joint Comm., *Options*, above n 10, 189 (opining that the current U.S. international tax system "arguably" impairs the competitiveness of U.S. multinationals "in some cases"); U.S. Treas. Dep't, *Background Paper*, above n 49, 43 ("[T]he United States likely experiences some reduction of both foreign direct investment and its corporate tax base due to its above-average CIT [corporate income tax] rate."). For a skeptical economic efficiency critique of the competitiveness arguments for the deferral subsidy, see Jane G. Gravelle, 'Foreign Tax Provisions of American Jobs Act of 1996' (1996) 72 *Tax Notes* 1165, 1168.

income tax regime⁷⁵ instead of by labor cost differentials, product quality differences, regulatory differences and other non-tax factors? Stated differently, if there are specific industries that face an international competitiveness problem, why is taxation the cause and how would adoption of an exemption proposal solve the problem? Answers to these questions have not been forthcoming.⁷⁶

Of course, an exemption advocate might shift ground by conceding that U.S. businesses are competing effectively abroad but then argue that this success is due to the generous tax assistance provided by the current U.S. regime,⁷⁷ that withdrawal of this aid would cause U.S. businesses to founder in foreign markets and that copious tax assistance should be continued but streamlined by substituting an exemption system for the more complex U.S. system of deferral, cross-crediting and other problematic features noted above. This argument, however, fails for the same reason as the basic competitiveness argument. Just as there is a paucity of evidence to support the allegation that U.S. businesses are at a competitive disadvantage because of the current U.S. international tax system, there is also an absence of evidence that their competitive success is due to the tax benefits provided by that system.⁷⁸

(c) Targeting

Not only is the need for competitive assistance highly doubtful in the U.S. context, but an exemption system would be a poor device for delivering the assistance. For example, under a territorial regime, exemption is fully available without regard to whether the beneficiary has little competition in the foreign country (for example, a pharmaceutical company selling one-of-a-kind patent-protected drugs⁷⁹) or faces fierce competition. In addition, exemption is fully available without regard to whether the exemption beneficiary's principal competitor in a particular foreign country is a resident of the beneficiary's country or is a foreign person. The struggle in foreign markets between U.S. software manufacturers and U.S. soft drink producers are examples of this case.⁸⁰ As these points illustrate, exemption systems are poorly targeted ways to enhance competitiveness vis-à-vis significant foreign competitors.

⁷⁵ See Mullins, *Moving to Territoriality*, above n 72, 844 ("[T]here is little evidence to assess the impact of U.S. taxes on the competitiveness of multinational corporations in foreign markets, and especially the extent to which competitiveness is affected by the use of the worldwide system").

⁷⁶ See Grubert and Mutti, *Taxing Multinationals*, above n 5, 446 ("The implication is that cutting tax on foreign income would not be a very effective way of encouraging U.S. R&D because it has little impact on foreign sales."); Grubert and Mutti, *Taxing Multinationals* at 453 ("Reducing U.S. taxes on foreign income does not seem to be any more effective in strengthening U.S. companies' worldwide competitiveness than reducing taxes on domestic corporate income.").

⁷⁷ See text accompanying above n 40-44.

⁷⁸ See U.S. Treas. Dep't, *Deferral* above n 47, 57 ("[T]he available data simply do not provide a reliable basis for evaluating whether...[the current U.S. international tax regime] has affected multinational competitiveness to any significant extent.").

⁷⁹ Another example is those markets where a United States multinational has established an overwhelming competitive position. See, eg, Nikhil Deogun, 'Australia Blocks Coke's Bid to Purchase Brands of Cadbury Schweppes There', *The Wall Street Journal* (New York City) Apr. 9, 1999, A3; Brandon Mitchener and Betsy McKay, 'EU Raids Coca-Cola's Offices in Four Countries', *The Wall Street Journal* (New York City) July 22, 1999, A4.

⁸⁰ See, eg, Don Clark and John R. Wilke, 'FTC Begins Formal Inquiry into Intel's Chip Pricing', *The Wall Street Journal* (New York City) June 7-8, 2008, A.3. A prominent example is the battle between Coca-Cola and Pepsi for dominance in some foreign markets. See, eg, Betsy McKay, 'PepsiCo CEO Adapts to Tough Climate', *The Wall Street Journal* (New York City) Sept. 11, 2008, B1; Betsy McKay, Sky Canaves and Geoffrey A. Fowler, 'Coke Deal Juices Its China Business', *The Wall Street*

Moreover, exemption of foreign-source income from a residence country's tax base erodes that base and contributes to the need for higher tax rates than would otherwise be the case. Those higher tax rates bring about distortions in economic behavior. Stated differently, given budgetary constraints, proposals to exempt foreign-source income from a residence country's tax base work at cross-purposes with proposals to reduce the distortionary effects of its tax system generally.⁸¹

Finally, even if we were to stipulate that the United States faces a systemic international competitiveness problem, it is doubtful that providing tax assistance to U.S. multinational corporations ranks very high among the potential remedies. For example, strengthening public education in the United States holds greater promise for effective results.⁸²

(d) Recapitulation

To summarize, it is quite clear that a territorial system distorts the business location decision and in the worst case scenario, encourages residents to pursue economically inferior opportunities in low-tax foreign countries. Moreover, it is also clear that the need to provide U.S. companies with generalized foreign competitive assistance has not been established and that even if competitive assistance were desirable, the territorial system would be a poorly targeted delivery device. In the U.S. context at least, when a territorial system's clear efficiency defects are weighed against its speculative benefits, it seems difficult to make a credible competitiveness case in favor of territoriality.

(e) Redefining Competitiveness

Finally, we question the validity of defining competitiveness in terms of the after-tax profitability of a country's multinational corporations instead of an improved living standard for its citizens.⁸³ When competitiveness is viewed in that latter way, the linkage, for example, between public investment in education and improved U.S.

Journal (New York City) Sept. 4, 2008, B1; Miriam Jordan, 'Debut of Rival Diet Colas in India Leaves a Bitter Taste', *The Wall Street Journal* (New York City) July 21, 1999, B1.

⁸¹ See text accompanying below n 120.

⁸² See Sara Murray, 'Study Finds Sharp Math, Science Skills Help Expand Economy', *The Wall Street Journal* (New York City) March 3, 2008, A2 (reporting on a study concluding that if U.S. students had achieved improvements in math and science called for by the National Governors Associations nearly 20 years ago, U.S. GDP would be 2 percentage points higher today and 4.5 points higher in 2015). See also, Conor Dougherty, 'High-Degree Professionals Show Power', *The Wall Street Journal* (New York City) Sept. 10, 2008, A3 ("In 2007, the median income [in the U.S.] for people with a bachelor's degree was about two-thirds more than those with only a high-school diploma.").

⁸³ The empirical evidence to date has failed to establish that expansion by U.S. multinationals into low-tax foreign countries results in net employment gains within the United States or net trade gains for the United States. See Martin A. Sullivan, 'Offshore Jobs and Taxes: Will Democrats Attack?' (2008) 119 *Tax Notes* 24; Martin A. Sullivan, 'U.S. Multinationals Moving Jobs to Low-Tax, Low-Wage Countries' (2008) 119 *Tax Notes* 119; Martin A. Sullivan, 'A Challenge to Conventional International Tax Wisdom', (2006) 113 *Tax Notes* 951, 956-58. See also Lawrence H. Summers, 'TCPI's Ninth Annual Tax Policy & Practice Symposium Keynote Address by Lawrence H. Summers' (June 2008) 86 *Taxes* 35, 40 (Statement by former U.S. Treasury Secretary that "I think the basic criterion for measuring national economic policy is what is happening to the growth in the incomes of average families....."); Graetz, Outdated Concepts, above n 47, 261, 294-95, 307.

The economic theories of capital export neutrality and capital import neutrality are concerned with maximizing global welfare rather than the welfare of residents of a particular country. See OECD, *Tax Effects*, above n 5, 96-100; Graetz, Outdated Concepts, above n 47, 270-73, 284-85.

competitiveness⁸⁴ is far more immediate and powerful than is a tax subsidy tailored to enhance the investment returns of U.S. multinational corporations.⁸⁵ Stated differently, it is difficult to see how an exemption system that abandons locational neutrality and encourages U.S. multinational corporations to shift investment capital to the Cayman Islands and Bermuda is improving the living standards of U.S. citizens and residents.

D *The New Ownership Neutrality Defense of Territoriality*

In a series of recent articles,⁸⁶ Professors Mihir A. Desai and James R. Hines Jr. have put forward a new theoretical defense of exemption, or territorial, systems under the rubric of ownership neutrality. According to Professors Desai and Hines, capital export neutrality and capital import neutrality — the traditional organizing principles for international tax policy debates — are seriously flawed.⁸⁷ Instead, they believe that “tax rules should be evaluated by the degree to which they ensure that the identities of capital owners are unaffected by tax rate differences, thereby permitting the market to allocate ownership rights to where they are most productive.”⁸⁸ Desai and Hines assert that the ownership neutrality concept yields two welfare benchmarks: capital ownership neutrality (CON) and national ownership neutrality (NON).⁸⁹ In their view, “CON requires that tax rules not distort ownership patterns”⁹⁰ and “implies that a reduction of U.S. taxation of foreign income [that is, a movement toward exemption, or territoriality] would improve worldwide welfare by moving U.S. taxation more in the direction of other countries that currently subject foreign income to little or no taxation.”⁹¹ Also, they assert that “NON...implies that the United States

⁸⁴ See Joann M. Weiner, ‘Conversations: Harvey S. Rosen’ (2007) 117 *Tax Notes* 857, 859 (“Empirical studies...show that the growth in income inequality is largely due to differences in educational attainment.... [T]hose who are less educated fall further behind.... [W]e need to focus on providing more education to these segments of the population.”).

⁸⁵ See J. Clifton Fleming Jr., Robert J. Peroni and Stephen E. Shay, ‘Point: The United States Should Tax U.S. Corporations on Their Worldwide Income’ (Fall 2001) *ABA Section of Taxation Newsletter Quarterly* 14, 15; authority cited in above n 82.

An additional way to view competitiveness is to compare full taxation of U.S. corporations that sell only in the U.S. market with exemption treatment for the foreign-source income of U.S. multinational corporations. Both groups of corporations compete for capital and the exemption for foreign-source income gives U.S. multinationals a competitive advantage over U.S. corporations that sell exclusively within the United States. There is no apparent justification for this disparity. See OECD, *Tax Effects*, above n 5, 96.

⁸⁶ See Mihir A. Desai and James R. Hines Jr., ‘Reply to Grubert’ (2005) 58 *National Tax Journal* 275 (hereinafter Desai and Hines, Reply); Mihir A. Desai and James R. Hines Jr., ‘Old Rules and New Realities: Corporate Tax Policy in a Global Setting’ (2004) 57 *National Tax Journal* 937 (hereinafter Desai and Hines, Old Rules); Mihir A. Desai, ‘New Foundations for Taxing Multinational Corporations’ (March 2004) 82 *Taxes* 39 (hereinafter Desai, New Foundations); Mihir A. Desai and James R. Hines Jr., ‘Evaluating International Tax Reform’ (2003) 56 *National Tax Journal* 487 (hereinafter Desai and Hines, Evaluating); See also Staff of Joint Comm. on Tax’n, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, JCX-68-03 (2003) 21-22 <<http://www.house.gov/jct/x-68-03.pdf>> (hereinafter Joint Comm., *U.S. Rules II*).

⁸⁷ See Desai and Hines, Old Rules, above n 86, 955-957; see also Graetz, Outdated Concepts, above n 47, 269-315.

⁸⁸ Desai, New Foundations, above n 86, 46.

⁸⁹ See Desai & Hines, Old Rules, above n 86, 956.

⁹⁰ *Ibid.*

⁹¹ *Ibid* 957; see also *ibid* 938 (“a movement to reform corporate taxation in the direction of exempting foreign income has a compelling logic”). Professors Desai and Hines have written that CON also could

would improve its own welfare⁹² by exempting foreign income from taxation.”⁹³ They conclude by stating that those “ownership based concepts of efficiency imply that national and world welfare would be advanced by reducing U.S. taxation of foreign income, thereby permitting taxpayers and the country to benefit from greater market-based allocation of resources to the most productive owners.”⁹⁴

1 *Efficiency Redux*

In our view, however, this new argument in favor of a U.S. exemption system is problematic. Consider the following variation of Example 1, *supra*:

Example 2. U.S. Multinational Inc. (USM) is a U.S. domestic corporation with skilled management and valuable intangibles that can be applied abroad. It pays U.S. tax on its worldwide income at a rate of 35 percent. Mediocre SA is a corporate resident of Country A, which exempts foreign business income from Country A’s income tax. Mediocre has no valuable business intangibles and its management is, indeed, mediocre. The assets of a business that earns only foreign-source income are for sale in Country X, a wonderful tax haven that has no tax on corporate profits and no withholding tax regime. A business is also for sale in the United States. USM has the resources to acquire one but not both of those businesses. USM can earn a 20 percent before-tax return on capital invested in the U.S. business and a 15 percent before-tax return if it purchases the assets of the Country X business. Because of Mediocre’s weak management and lack of business intangibles, it can earn only a 10 percent return if it purchases the assets of the Country X business.

If USM’s only option were to operate the Country X business as a branch so that deferral of U.S. tax on the Country X business income was not available, the 35 percent current U.S. tax on USM’s profits from the Country X business would leave it with a 9.75 percent after-tax return.⁹⁵ By contrast, Mediocre’s after-tax return from that business would equal its 10 percent before-tax return because of the exemption system employed by Mediocre’s home country. Thus, Mediocre presumably would outbid USM for the Country X business with the result that the business would

be achieved if all countries use worldwide systems with unlimited foreign tax credits. See Desai and Hines, *Evaluating*, above n 86, 492, 494. But that is a purely academic point because it is not now the case — and it is unlikely ever to be true — that all the world’s countries employ worldwide taxation systems with unlimited foreign tax credits. See Grubert and Mutti, *Taxing Multinationals*, above n 5, 441.

⁹² Desai and Hines define welfare improvement as increases in “tax collections as well as private incomes.” Distributional or fairness considerations do not seem to have a role in their approach, see Desai, *New Foundations*, above n 86, 45, which in our view is a serious defect. Cf Fleming, Peroni and Shay, *Fairness*, above n 2.

⁹³ Desai and Hines, *Old Rules*, above n 86, 957.

⁹⁴ *Ibid.*

⁹⁵ $0.15 \times (1 - 0.35) = 0.0975$.

wind up in the hands of the less-productive owner.⁹⁶ Under Professors Desai's and Hines's concept of ownership neutrality, that is a bad outcome. Of course, if USM operated the Country X business through a CFC, USM could, in a best-case scenario, get close to a 15 percent after-tax return from the Country X investment by taking advantage of deferral.⁹⁷ But that pathway to an approximately 15 percent after-tax return can be complex and, according to Professors Desai and Hines, many U.S. taxpayers continue to suffer a substantial U.S. tax burden on their foreign income despite the CFC alternative.⁹⁸ Accordingly, they argue that the United States should adopt an exemption system so that in a more certain and straightforward way, USM's after-tax return from investing in the Country X business would equal its 15 percent pre-tax return and USM would outbid Mediocre, which is limited by its mediocrity to a 10 percent return from the Country X business.⁹⁹

Adoption of a U.S. exemption system would mean, however, that USM would prefer the Country X investment to purchasing the U.S. business even though the latter is economically superior to the Country X investment. That is because USM's 20 percent before-tax return from investing in the U.S. business would be reduced to 13 percent by the 35 percent U.S. tax on domestic income¹⁰⁰ while the U.S. exemption system for foreign income would give USM a 15 percent return on its investment in the Country X business. Thus, the exemption system would cause USM to forgo the economically superior purchase of the U.S. business in favor of the economically inferior acquisition of the Country X business.¹⁰¹

Exemption systems are usually justified by reference to the doctrine of capital import neutrality (CIN)¹⁰² and the preceding illustration of how a hypothetical U.S.

⁹⁶ See generally Desai and Hines, *Evaluating*, above n 86, 491-492.

⁹⁷ See U.S. Treas. Dep't, *Deferral*, above n 47, x; text accompanying above n 25-30.

⁹⁸ See Desai and Hines, *Old Rules*, above n 86, 943-955. Professors Desai and Hines have stated: "[I]t is useful to assume that current U.S. taxation neutralizes roughly half of the benefit of earning profits in low-tax locations." Desai and Hines, *Old Rules* 954. But see Harry Grubert, 'Comment on Desai and Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Setting"' (2005) 58 *National Tax Journal* 263 (hereinafter Grubert, Comment) (disputing Desai's and Hines's computations).

⁹⁹ See Desai, *New Foundations*, above n 86, 236.

¹⁰⁰ $0.20 \times (1 - 0.35) = 0.13$.

¹⁰¹ See Reuven S. Avi-Yonah, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573, 1604 n.132 (hereinafter Avi-Yonah, *Globalization*); Roseanne Altshuler, 'Recent Developments in the Debate on Deferral' (2000) 20 *Tax Notes International* 1579, 1581-1582; Grubert, Comment, above n 98, 271; See also Commission of the European Communities, above n 11, 18.

¹⁰² See OECD, *Tax Effects*, above n 5, 98. The doctrine of CIN holds that all capital income should be taxed at the same rate regardless of the taxpayer's residence country. See, eg, Gustafson, Peroni and Pugh, above n 1, 18. In the example involving USM, CIN would require that income earned by USM from operating the Country X business be exempt from taxation by USM's residence country (the United States) because the income's source would be a country that applied a zero tax rate. See Joint Comm., *Options*, above n 10, 186.

exemption system would cause USM to make the economically less-desirable Country X investment illustrates the classic efficiency objection to CIN and to exemption systems.¹⁰³ By contrast, a worldwide system without deferral would cause USM to pay a current 35 percent U.S. residual tax on income from the Country X business (there would be no credit for Country X tax because the Country X rate is assumed to be zero). Thus, USM's 15 percent before-tax return in Country X would be reduced to a 9.75 percent after-tax return¹⁰⁴ and USM would choose to enjoy the 13 percent after-tax return¹⁰⁵ of the economically preferable U.S. business. In other words, the after-tax result of the worldwide system, without deferral, would not disturb the pre-tax superiority of the U.S. investment¹⁰⁶ and taxes would be a neutral factor in USM's choice between purchasing the U.S. business or the Country X business.

2 *What is Neutrality and What Is Distortion?*

Professors Desai and Hines, however, seem to argue that the worldwide system is actually nonneutral in USM's case because it would cause USM to choose the economically preferable U.S. business instead of the deficient Country X business.¹⁰⁷ That raises the question of which is the benchmark for determining the existence of distortion — decisions made by residents under a home country's worldwide system or decisions made by residents under a home country's exemption, or territorial, system? Because it is clear that worldwide taxation of residents is normatively permissible,¹⁰⁸ affirmatively required by fairness considerations,¹⁰⁹ and more closely aligned than is territoriality with the results that would occur in a world where all income and taxpayers were treated uniformly, it is our view that worldwide taxation should be regarded as the benchmark of neutrality and territorial taxation as the distortive approach.¹¹⁰ Thus, in Example 2, adopting a U.S. exemption system would be a distortive move that would cause a welfare loss to both the United States and the world economy on account of USM's choosing the economically inferior Country X investment.

¹⁰³ See text at above n 68-71; Gustafson, Peroni and Pugh, above n 1, 19.

¹⁰⁴ See above n 95.

¹⁰⁵ See above n 100.

¹⁰⁶ Indeed the relationship of the after-tax returns from the two businesses ($0.0975/0.13 = 0.75$) would be identical to the relationship of the before-tax returns ($0.15/0.20 = 0.75$).

¹⁰⁷ "Exempting foreign income from U.S. taxation would be associated with 40 percent greater outbound FDI. . . . U.S. taxation of foreign income impairs the productivity of American firms in the global marketplace . . . since it distorts ownership patterns." Desai and Hines, *Old Rules*, above n 86, 954, 957; See also Desai and Hines, *Reply*, above n 86, 275, 277-278; Desai and Hines, *Evaluating*, above n 86, 491, 494.

¹⁰⁸ See Hugh J. Ault and David F. Bradford, 'Taxing International Income: An Analysis of the U.S. System and Its Economic Premises' in Assaf Razin and Joel Slemrod (eds) *Taxation of the Global Economy* (1990) 11, 31; United States Treasury Department, *Blueprints for Basic Tax Reform* (1977) 99 <<http://www.ustreas.gov/offices/tax-policy/library/blueprints>> (hereinafter U.S. Treas. Dep't, *Blueprints*).

¹⁰⁹ See Part III.E, below.

¹¹⁰ See generally Commission of the European Communities, above n 11, 18 ("Resources are misallocated in so far as capital inputs are directed from their most productive uses — that is, those with the highest rates of return before taxes — to locations where such inputs are less productive, but yield greater after-tax returns as a consequence of their relatively favorable tax treatment.'").

3 Offsets?

Professors Desai and Hines recognize that a U.S. exemption system would provide USM with a tax incentive to purchase the inferior business in low-tax Country X, but they regard that economic loss as possibly being offset by the fact that the Country X business would be in the hands of the most productive owner, USM. They state their view as follows:

Whether the cost of having too many factories in the Bahamas [a tax haven] is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an empirical question, though the importance of ownership to FDI [foreign direct investment] suggests that its welfare impact may also be substantial.¹¹¹

But the economic gain from USM's acquisition of the Country X business would offset the economic loss from USM's passing up the U.S. business only if USM could wring a before-tax return from the Country X business that was at least equal to the before-tax return from the U.S. business. And if that were the case, an exemption system would be unnecessary because a worldwide system without deferral would preserve the comparative attractiveness of the Country X business, and therefore the worldwide system would not stand in the way of USM's acquiring that business.¹¹² More importantly, in the situation where the before-tax return from the Country X business was less than the before-tax return from the U.S. business, a U.S. exemption system would encourage USM to buy the Country X business (if the Country X business had a better *after-tax* return) even though the benefit from USM's doing so would not offset the loss from USM's forgoing the superior U.S. investment.

4 Foreign Capital Inflows

Professors Desai and Hines have a tentative response to all that. In their view, it is true that individual U.S. firms are forced by their resource limitations to choose between investment alternatives,¹¹³ just as USM had to choose either the U.S. business or the Country X business in Example 2. But they point out that there is a global pool of capital, and they say that it is "conceivable" that an owner of foreign-invested capital would come forward and make the U.S. acquisition that was forgone by USM in favor of the Country X investment.¹¹⁴ *If* that happened, and *if* the owner of the foreign-invested capital could squeeze the same 20 percent before-tax return from the U.S. business that USM was capable of, U.S.-source tax on that capital owner's U.S. return would make the Treasury whole and in addition, neither the U.S.

¹¹¹ See Desai and Hines, *Evaluating*, above n 86, 495-496.

¹¹² See text accompanying above n 103-106.

¹¹³ See Desai and Hines, *Reply*, above n 86, 277 n.4.

¹¹⁴ See Desai and Hines, *Old Rules*, above n 86, 956. That represents a muting of their position in Desai and Hines, *Evaluating*, above n 86, 496 (emphasis added), in which they said that "additional outbound foreign investment *does not* reduce domestic tax revenue, since any reduction in home-country investment *is* offset by greater investment by foreign firms." (Emphasis added.) Professor Hines, writing alone, repeated this statement in Hines, *Reconsidering*, above n 72, 12. See also Tuerff, Shaviro, Shackleford, McDonald and Mundaca, above n 11, 78 (statement by Daniel Shaviro that "[e]ven if a U.S. multinational does reduce investment at home by reason of its investing abroad, this may create a vacant slot here for someone else to fill."); Jackson, above n 33, 899 (reporting an argument made by some academics that "[w]hen a company moves overseas, it also opens up a slot in the United States into which a foreign firm can move, thereby resupplying the jobs lost from the original shift abroad").

economy nor the global economy would suffer a productivity loss from USM's decision to acquire the inferior Country X investment.

But Professors Desai and Hines are not entirely certain that the foreign-invested capital would, in fact, be shifted to the United States. They soften their analysis with qualifiers as follows:

The modern view of FDI as arising from productivity differences among firms, with ownership changes taking the form of FDI, raises the *possibility* that greater outbound FDI need not be associated with reduced domestic investment. Indeed, it is *conceivable* that greater outbound FDI is associated with greater domestic investment, either by home country firms undertaking the FDI or by unrelated foreign investors.¹¹⁵

Indeed, it seems unwise to assume that foreign-invested capital¹¹⁶ will invariably make the U.S. Treasury and domestic economy whole regarding decisions by corporations like USM to forgo U.S. investments in favor of less productive investments in other countries. Volatility in the value of the dollar can discourage investment from abroad.¹¹⁷ Moreover, the necessary foreign capitalists may be exemption-country residents who find tax-free investments in low-tax jurisdictions like Country X more attractive than investing in a U.S. business and incurring a 35 percent U.S.-source tax on the profits of that business. In short, it is less than certain that foreign capital would substantially replace the capital that would be deflected from the more productive U.S. domestic investment if USM were to pursue the inferior Country X investment. And if the alleged disadvantages of U.S. businesses passing into foreign control and shifting their headquarters overseas are true,¹¹⁸ as many proponents of exemption or territorial systems maintain,¹¹⁹ having a foreign investor make up for USM's outbound capital flow by acquiring the U.S. business that was passed over by USM is not a happy solution. Finally, even if foreign capital does replace outbound domestic capital, why should the United States provide a tax subsidy to encourage wealthy U.S. multinationals to purchase inferior investments abroad, thereby creating a capital vacuum to be filled by foreign investors? Because of those factors, it seems improvident for the United States to adopt an exemption system that would have the inevitable effect of giving USM a substantial incentive to forgo the U.S. investment in favor of the inferior Country X investment.

5 Competitiveness Redux

If, however, USM could squeeze, say, a 25 percent before-tax return out of the Country X investment, it would be economically efficient for USM to forgo the U.S. alternative and acquire the Country X business. In that scenario, a U.S. worldwide taxation system, without deferral, would impose a 35 percent residence-based tax on

¹¹⁵ Desai and Hines, *Old Rules*, above n 86, 956 (emphasis added).

¹¹⁶ If capital already invested in the United States were used to make the U.S. acquisition that USM declined to undertake, the acquisition would not offset the capital outflow caused by USM's purchase of the Country X business.

¹¹⁷ See Ian McDonald, 'As U.S. Stocks Stall, Foreign Issues Catch On', *The Wall Street Journal* (New York City) July 14, 2005, C1.

¹¹⁸ See 'Congress Raises New Roadblock to CNOOC's Path to Unocal Deal', *The Wall Street Journal* (New York City) July 27, 2005, C4; Martin A. Sullivan, 'The Deficit Tax' (2005) 108 *Tax Notes*, 62, 63; U.S. Treas. Dep't, *Corporate Inversion Transactions: Tax Policy Implications* (2002) 20; NFTC, *International Tax Policy*, above n 72, 114.

¹¹⁹ See Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (1992) 77-94, 131-136.

the 25 percent Country X return, thus reducing it to 16.25 percent after tax. But that would be better than the 13 percent after-tax return USM could earn on the U.S. investment and USM would pursue the purchase of the more productive Country X business.

Nevertheless, USM's pursuit might be unsuccessful, because any exemption-country resident who could produce a greater than 16.25 percent before-tax return from the Country X business could theoretically outbid USM and make the acquisition even though USM, with its 25 percent before-tax return, would be economically preferable to any foreign acquirer whose potential before-tax return fell below 25 percent. That leads to the argument that the U.S. system of worldwide taxation exposes U.S. corporations to being outbid for attractive acquisitions in low-tax countries by exemption-country residents¹²⁰ and that the United States should prevent that from happening by adopting an exemption regime even though doing so would also amount to providing U.S. corporations with the above-described incentive to forgo more productive U.S. investments in favor of economically inferior foreign investments.

That argument is rendered dubious, at best, by the extensive overseas success of American businesses¹²¹ and their numerous acquisitions of foreign companies.¹²² There is no empirical evidence that U.S. multinational corporations are being consistently outcompeted for acquisitions or customers in low-tax countries by exemption-country residents.¹²³ Moreover, a program of aiding United States corporations by relieving their foreign-source income from U.S. tax would be a poorly structured tax assistance measure. That is because the tax assistance would be fully available to U.S. corporations that are earning supernormal returns in low-tax foreign countries because they are selling patent- or copyright-protected goods. Also, exemption would be fully available to a U.S. corporation whose principal competitor in a low-tax foreign country is another U.S. corporation. Finally, an exemption system would conflict with the U.S. goal of operating an income tax based on the principle of ability-to-pay because it ignores the taxpaying capacity represented by foreign-source income.¹²⁴ Thus, it seems unwise to provide a tax subsidy, in the form of an exemption system, to wealthy U.S. multinationals, particularly when the United States is running large

¹²⁰ See OECD, *Tax Effects*, above n 5, 100; Julie Roin, 'Comments on Mihir A. Desai's New Foundations for Taxing Multinational Corporations' (March 2004) 82 *Taxes* 157, 158 (hereinafter Roin, Comments).

¹²¹ See authorities cited in above n 73.

¹²² See Staff of Joint Committee on Taxation, *The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations*, JCX-67-03 (2003) 35-36, A-7 <<http://www.house.gov/jct/x-67-03.pdf>> (hereinafter Joint Comm., *U.S. Rules I*).

¹²³ See U.S. Treas. Dept., *Deferral*, above n 47, 56-57, 61. Indeed, exemption system countries in Western Europe have not found that the exemption approach alone is sufficient to ensure overall economic success. See Jonathan House and Emma Charlton, 'Gloom Spreads in EU's Economies', *The Wall Street Journal* (New York City) Nov. 1-2, 2008, A8; Marcus Walker, 'Euro Zone Faces Several Hurdles to Steady Growth', *The Wall Street Journal* (New York City) Nov. 16, 2005, A16; Martin A. Sullivan, 'German Unemployment Drives Tax Reform' (2005) 39 *Tax Notes International* 479; 'Euro Zone's Growth Potential Looks to Weaken in Long Term', *The Wall Street Journal* (New York City) July 13, 2005, A13; Marc Champion, Dan Bilefsky, and John Carreyrou, 'A French 'No' Reminds Europe of Many Woes', *The Wall Street Journal* (New York City) May 31, 2005, A1.

¹²⁴ See generally Fleming, Peroni and Shay, *Fairness*, above n 2; Joint Comm., *U.S. Rules II*, above n 86, 3; United Kingdom Inland Revenue, *Double Taxation Relief for Companies* (1999) 11, 14.

deficits that significantly constrain its ability to deal with healthcare, education, homeland security, natural disaster relief and many other similar needs.¹²⁵

The goal of ownership neutrality is to permit the market to allocate ownership of business assets to the most productive players.¹²⁶ For Professors Desai and Hines, the phrase “most productive players” means those who can produce the largest before-tax returns.¹²⁷ Thus, their ownership neutrality concept is internally flawed because it advocates exemption systems,¹²⁸ which often drive a wedge between investors and the largest before-tax returns.¹²⁹ At the end of the day, the ownership neutrality concept advanced by Professors Desai and Hines suffers from the same economic efficiency and fairness flaws as does CIN and, like CIN, ultimately can be defended only by resorting to a competitiveness argument.¹³⁰ In the context of ownership neutrality, the concept of competitiveness means the ability to succeed in bidding for ownership of assets. This is slightly different from the competitiveness concept that is more commonly used to defend exemption systems through reliance on CIN. That latter competitiveness concept focuses on the ability to gain market share. But the difference is not significant with respect to the worldwide taxation versus territorial taxation debate because with respect to both competitiveness concepts there is no convincing evidence of a general competitiveness problem, and both competitiveness concepts produce results that conflict with the ability-to-pay norm¹³¹ and fail under conventional tax expenditure analysis.¹³²

6 Tax Competition

But what about Country X in the preceding example, whose effort to attract U.S. investors by offering them a zero tax rate is being undermined by U.S. taxation of U.S. residents’ foreign-source income? Some commentators argue that adoption of an exemption system is necessary to allow developing countries to use tax holidays to attract badly needed foreign investment.¹³³ It seems to us, however, that the primary obligation of U.S. tax policy is to improve the well-being of U.S. individuals.¹³⁴ The United States has no obligation to facilitate the tax competition efforts of other countries.¹³⁵ The United States may, however, find that there are good reasons to do

¹²⁵ See Committee for Economic Development, *A New Tax Framework: A Blueprint for Averting a Fiscal Crisis* (2005) 7-11 <http://www.ced.org/docs/report_tax2005.pdf>; Andy Pasztor, ‘Budget Pressures May Imperil Pentagon’s New-Breed Satellites’, *The Wall Street Journal* (New York City) Nov. 19-20, 2005, A4.

¹²⁶ See text accompanying above n 86-99.

¹²⁷ See above n 99.

¹²⁸ See text accompanying above n 86-94.

¹²⁹ See text accompanying above n 68-71, 99-101.

¹³⁰ See Roin, Comments, above n 120, 158.

¹³¹ See text accompanying below n 143-212.

¹³² See generally, Fleming and Peroni, Tax Expenditure Analysis, above n 10, 547-51. For additional criticism of the ownership neutrality concept, see OECD, *Tax Effects*, above n 5, 101-02.

¹³³ See, eg, Karen B. Brown, ‘Transforming the Unilateralist Into the Internationalist’, in Karen B. Brown and Mary Louise Fellows (eds), *Taxing America* (1996) 214; Karen B. Brown, ‘Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?’ (2002) 23 *University of Pennsylvania Journal of International Economic Law* 45. For criticism of the ultimate effectiveness of tax inducements offered by developing countries, see Christian Aid, ‘The Shirt Off Their Backs: How Tax Policies Fleece the Poor’, (2005) 40 *Tax Notes International*, 617; Avi-Yonah, Globalization, above n 101, 1639-1648.

¹³⁴ See Graetz, Outdated Concepts, above n 47, 277-279, 311.

¹³⁵ See Commission of the European Communities, above n 11, 20; OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998) 15.

so with respect to particular countries. If the United States desires to provide badly needed financial assistance to those developing countries that are acting responsibly in terms of human rights, the rule of law, nonaggression toward neighbors and other similar issues (a worthy objective of U.S. foreign policy), bilateral negotiations leading to treaty-based U.S. tax-sparing benefits for those particular countries is a more focused and hence better approach than an exemption system that would indiscriminately benefit all low-tax countries no matter how prosperous, oppressive or hostile they might be.¹³⁶ In the alternative, tax expenditure analysis would support using targeted direct grants in lieu of an indirect and unfocused tax subsidy in the form of an exemption system.¹³⁷

7 Summary

The ownership neutrality form of analysis purports to identify benefits that make territoriality superior to worldwide taxation. When subjected to close scrutiny, however, those benefits seem unlikely to occur. Thus, territoriality remains in the unacceptable position of imposing costs that are real (i.e., substantial economic distortion) in the hope of achieving competitiveness benefits that are speculative at best.

E Tax Expenditure Analysis

To argue that countries should grant a tax exemption for foreign-source income earned by resident companies in order to make those companies more competitive in foreign markets is to argue that resident companies should receive financial assistance through the income tax system. Thus, the competitiveness argument in favor of territoriality is ultimately a confession that a territorial system is a tax expenditure.¹³⁸ As such, it should be subjected to the cost/benefit scrutiny demanded by tax expenditure analysis.¹³⁹ In our view, the juxtaposition of the undisputed distortive consequences of territorial systems against their doubtful benefits leads to an unfavorable cost/benefit ratio.¹⁴⁰

Moreover, tax expenditure analysis requires that the revenue loss from tax expenditures should be considered in light of alternative uses for that revenue. In the context of the worldwide versus territoriality debate, this means that the desirability of devoting scarce revenue to increasing the profitability of the foreign operations of residence country companies should be balanced against the benefits to be gained from using that revenue to reduce distortions in the tax system by cutting income tax rates across the board¹⁴¹ and/or using that revenue for some or all of the following:

¹³⁶ See text accompanying below n 230-48; Fleming, Peroni and Shay, *Fairness*, above n 2, 344-349; Robert J. Peroni, 'Response to Professor McDaniel's Article', (2003) 35 *George Washington International Law Review* 297, 299-300.

¹³⁷ See Fleming, Peroni and Shay, *Fairness*, above n 2, 344-346; Peroni, above n 136, 297-299.

¹³⁸ See Fleming and Peroni, *Tax Expenditure Analysis*, above n 10, 439-40.

¹³⁹ See *ibid* 487-88, 525-27.

¹⁴⁰ See text accompanying above n 50-132.

¹⁴¹ See OECD, *Tax Effects*, above n 5, 22 ("A low tax rate benefits all corporations, which also reduces incentives to shift activities and tax base offshore."); Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2008) 123 ("In my view, the most important corporate tax change Congress could enact—both to stimulate our domestic economy and to increase the competitiveness of U.S. companies throughout the world—would be to lower our corporate tax rate substantially."); Grubert and Altshuler, *Corporate Taxes*, above n 5, 2 ("A lower

improved healthcare funding, improved educational funding,¹⁴² increased assistance to the poor, infrastructure needs and environmental protection. Each country must decide for itself how to balance these competing revenue needs. The important point, however, is that territoriality involves a diversion of scarce tax revenue to a particular use and that there should be a public debate over whether this diversion is appropriate in the light of other uses to which the revenue could be put.

F *Fairness Considerations*

1 *Introduction*

The worldwide versus territoriality debate has been conducted primarily in terms of the economic concept of efficiency. The debate does, however, involve important fairness considerations involving the principle of ability-to-pay. Nevertheless, there has been relatively little discussion in the literature regarding the role of the ability-to-pay fairness concept in analyzing international tax policy issues.¹⁴³ This may be because the composition of international investment historically has been dominated by the direct foreign investments of multinational corporations, which pose perplexing issues in evaluating fairness concerns.¹⁴⁴ Even if true, however, this is an inadequate reason to forego analysis of fairness considerations when scrutinizing the important international dimension of a modern income tax.¹⁴⁵ We now turn to an examination

corporate rate reduces the incentives for shifting income out of the United States, which both loses revenue and magnifies the attractiveness of investing in low-tax locations.”); Jackson, above n 33, 899 (reporting on a Procter & Gamble financial executive arguing that “the United States must radically cut its corporate tax to attract capital and spur economic growth.”); Martin A. Sullivan, ‘Beyond the Conventional Wisdom: Rate Cuts Beat Expensing’ (2008) 118 *Tax Notes* 456, 465 (“[A] rate cut reduces the incentive to artificially shift profits, and rate cuts equally attract high—and normal—profit investments across national borders.”); Joel Slemrod and Jon Bakija, *Taxing Ourselves* (3d ed 2004) 193 (“Other things being equal, lower marginal rates are better for the economy....”). See also Aviva Aron-Dine, ‘Fiscally Responsible Corp. Tax Reform Could Benefit the Economy’ (2008) 120 *Tax Notes* 691; Joint Comm., *Alternative U.S. tax Policies*, above n 6, 57 (“[T]he total tax burden on U.S. multinationals in the aggregate could be expected to increase [following replacement of the present U.S. international regime with a well-designed worldwide system] unless adoption of the system is accompanied by a reduction of the U.S. tax rate.”). See Grubert and Altshuler, *Corporate Taxes*, above n 5, 5, 34-39 for a proposal to effect a revenue-neutral replacement of the present U.S. international system with a worldwide system.

¹⁴² See Sara Murray, ‘Study Finds Sharp Math, Science Skills Help Expand Economy’, *The Wall Street Journal* (New York City) March 3, 2008, A2 (reporting on a study concluding that if U.S. students had achieved improvements in math and science called for by the National Governors Association nearly 20 years ago, U.S. GDP would be 2 percentage points higher today and 4.5 points higher in 2015). See also above n 84.

¹⁴³ Professor Michael Graetz has challenged “[t]he focus in the international income tax literature on economic efficiency to the exclusion of all other values” as a criterion for U.S. international tax policy and asserted that “deciding to tax income reflects a decision to place issues of fairness at the heart of tax policy debates. That commitment cannot be ignored simply because income traverses national borders.” Graetz, *Outdated Concepts*, above n 47, 294, 307. For an article that focuses on fairness considerations in international taxation, see Nancy H. Kaufman, ‘Fairness and the Taxation of International Income’, (1998) 29 *Law and Policy in International Business* 145.

¹⁴⁴ See text accompanying below n 176-210.

¹⁴⁵ Moreover, since the 1990s, cross-border U.S. portfolio investment has exceeded U.S. multinationals’ cross-border direct investment in volume. See NFTC, *International Tax Policy* above n 72 at 98-99; Graetz, *Outdated Concepts*, above n 47, 263-67. In the decade of the 1990s, cross-border direct investment increasingly was engaged in by private equity partnerships that amassed \$1 billion or more from individuals and tax-exempt institutional investors.

of the role that fairness concerns, embedded in the ability-to-pay concept, play in justifying the U.S. policy of taxing U.S. residents on their worldwide incomes.

2 Ability-to-Pay

(a) The Deference Accorded to Ability-to-Pay

Ultimately, taxes that support any government and its direct expenditure programs are borne by individuals.¹⁴⁶ In that regard, the U.S. socio-economic consensus recognizes that one of the most important criteria for spreading the income tax burden among individual taxpayers is the proposition that this onus should be allocated on the basis of comparative economic well-being,¹⁴⁷ often referred to as ability-to-pay.¹⁴⁸

¹⁴⁶ See United States Treasury Department, *Distributional Analysis Methodology*, OTA Paper No. 85 (1999) 1 <<http://www.ustreas.gov/offices/tax-policy/library/ota85.pdf>> (hereinafter U.S. Treas. Dep't, *Distributional Analysis*); David F. Bradford, *Untangling the Income Tax* 33-34, 148-49 (1986); Slemrod and Bakija, above n 141, 72-85; George K. Yin, 'The Future Taxation of Private Business Firms', (1999) 4 *Florida Tax Review* 141,153-54 (hereinafter Yin, *The Future*).

¹⁴⁷ There is currently a sharp debate over whether economic well-being should be measured by reference to income that is both saved and consumed or only by reference to consumption. See, eg, U.S. Treas. Dep't, *Blueprints*, above n 108, 38-42; United States Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* (1984) vol 1, 198-200 (hereinafter U.S. Treas. Dep't, *Tax Reform*); Joseph M. Dodge, J. Clifton Fleming, Jr. and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure and Policy* (3d ed 2004) 67-76, 138-49; William D. Andrews, 'A Consumption-Type or Cash Flow Personal Income Tax' (1974) 87 *Harvard Law Review* 1113; Joseph Bankman and Barbara H. Fried, 'Winners and Losers in the Shift to a Consumption Tax' (1998) 86 *Georgetown Law Journal* 539; Bruce Bartlett, 'The End of Tax Expenditures As We Know Them?', (2001) 92 *Tax Notes* 413, 420-22; J. Clifton Fleming, Jr., 'Replacing the Federal Income Tax with a Postpaid Consumption Tax: Preliminary Thoughts Regarding a Government Matching Program for Wealthy Investors and a New Tax Policy Lens' (2006) 59 *Southern Methodist University Law Review* 617 <<http://ssrn.com/abstract=940699>>; John K. McNulty, 'Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform' (2000) 88 *California Law Review* 2095; Alvin C. Warren, Jr., 'Would a Consumption Tax Be Fairer Than an Income Tax?' (1980) 89 *Yale Law Journal* 1081. Moreover, the present income tax is generally recognized as being an income tax with important consumption tax elements. See, eg, U.S. Treas. Dep't *Blueprints*, above n 108, 33-35; Bradford, above n 146, 8, 28-29; Fleming and Peroni, *Tax Expenditure Analysis*, above n 10, 508-17. The current hybrid nature of the income tax does not, however, affect the analysis in this article because the U. S. income tax is predominantly based on the taxation of both income that is consumed and income that is saved, See Fleming and Peroni, *Tax Expenditure Analysis*, above n 10, 508-17, and the analysis herein is consistent with such a tax. This article is premised on the assumption that the United States will not in the foreseeable future rely principally on consumption taxes for federal revenue.

¹⁴⁸ See *Report on Double Taxation*, League of Nations Doc. E.F.S. 73.F.19. at 18 (1923), in Staff of Joint Committee on Taxation, *Legislative History of United States Tax Conventions* (1962) vol 4, 4003,4022 (hereinafter *Report on Double Taxation*); U.S. Treas. Dep't, *Blueprints*, above n 108, 1, 24; Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (4th ed, 1984) 232-240; Slemrod and Bakija, above n 141, 62-64, 163; Stephen G. Utz, *Tax Policy* (1993) 31-32, 41; Graetz, *Outdated Concepts*, above n 47, 295; Robert A. Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 *Cornell Law Review* 18, 29; Martin J. McMahon, Jr. and Alice G. Abreu, 'Winner-Take-All Markets: Easing the Case for Progressive Taxation' (1998) 4 *Florida Tax Review* 1, 66-71; Robert L. Palmer, 'Toward Unilateral Coherence in Determining Jurisdiction to Tax Income' (1989) 30 *Harvard International Law Journal* 1, 9-10; Joseph T. Sneed, 'The Criteria of Federal Income Tax Policy' (1965) 17 *Stanford Law Review* 567, 574-80; see also U.S. Treas. Dep't. *Distributional Analysis*, above n 146, § 5. For a discussion of the use of fairness considerations in defining income, see Victor Thuronyi, 'The Concept of Income', (1990) 46 *Tax Law Review* 45.

There are, of course, many occasions when ability-to-pay must yield to other considerations,¹⁴⁹ but it is usually given great weight in the domestic tax policy process.¹⁵⁰ There is no reason why it should not receive similar deference when international tax provisions are being scrutinized.

One may, of course, dissent from this consensus and contend that the tax burden should be allocated on some basis other than ability-to-pay. Nevertheless, since ability-to-pay is the prevailing fairness dogma under our current income tax system, its implications regarding the issue of worldwide versus territorial taxation should be analyzed even if one might prefer a different doctrinal approach.

(b) *Whose Ability-to-Pay?*

But whose ability-to-pay is relevant in an international context? Which individuals should be included in the group that bears the portion of government cost funded by the individual income tax? Certainly, individuals should be taken into account if their connection with U.S. society is so substantial that fundamental fairness requires their net incomes to be compared with the net incomes of other U.S. residents for purposes of making an equitable allocation of the tax burden under an ability-to-pay system.¹⁵¹

Those who continuously live year-round in the United States easily satisfy this standard but there is less clarity when the connection with the United States is less extensive. Congress has drawn lines to deal with this issue¹⁵² and one can debate

Indeed, the familiar Schanz-Haig-Simons definition of income, see Henry Simons, *Personal Income Taxation* (1938) 50, is principally based on the ability-to-pay concept. See U.S. Treas. Dep't, *Blueprints*, above n 108, 31; U.S. Treas. Dep't, *Distributional Analysis*, above n 146, § 5.1; Dodge, Fleming, and Geier, above n 147, 137; See also Joseph M. Dodge, 'What's Wrong with Carryover Basis Under H.R. 8' (2001) 91 *Tax Notes* 961, 971 (suggesting that the assignment of income doctrine, a core principle in the U.S. federal income tax, may be based on the ability-to-pay concept).

Ability-to-pay is a foundational principle in the income tax systems of many countries in addition to the United States. See Henry Ordower, 'Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted', (2006) 7 *Florida Tax Review* 259, 304; Frans Vanistendael, 'Legal Framework for Taxation' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (1996) vol 1, 15, 22-23. The ability-to-pay principle has even been made a constitutional limitation on the power to tax income in Italy, Spain and Germany. See Frans Vanistendael, *Legal Framework for Taxation* at 15, 22-23. See also *Basic Facts About the United Nations, The United Nations: Organization* (2008) <<http://www.un.org/aboutun/basicfacts/unorg.htm>> at 30 October 2008 ("The fundamental criterion on which the scale of assessments is based is the capacity of countries to pay.").

For recent criticism of the ability-to-pay concept, see Liam Murphy and Thomas Nagel, *The Myth of Ownership* (2002) 20-30. For a recent vigorous defense of ability-to-pay see Joseph M. Dodge, 'Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles' (2005) 58 *Tax Law Review* 399 (hereinafter Dodge, Theories). For a discussion of difficulties that arise when individual utility, or welfare, is used as the principal fairness norm instead of ability-to-pay, see Brian Galle, 'Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction' (2008) 106 *Michigan Law Review* 805, 842-46.

¹⁴⁹ See 'Forward' in United States House of Representatives Committee on Ways and Means, *Tax Revision Compendium* (1959) vol 2, ix (hereinafter House Comm., *Compendium*); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, (1996) 16 *Virginia Tax Review* 39, 99-101. These other considerations include economic efficiency, simplicity and administrability. See U.S. Treas. Dep't., *Blueprints*, above n 108, 1-2; U.S. Treas. Dep't, *International Tax Reform: An Interim Report* (1993) ch I, §§ A, B; U.S. Treas. Dep't, *Tax Reform*, above n 147, 13-20; Sneed above n 148, 567.

¹⁵⁰ See, eg, U.S. Treas. Dep't, *Tax Reform*, above n 147, 25-26; Sneed, above n 148, 579-80, 601-02; See also McMahon and Abreu, above n 148, 65-71.

¹⁵¹ See generally Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. (1984) 463-65; *Report on Double Taxation*, above n 148, 18-20; Arnold and McIntyre, above n 1, at 17; Ault and Arnold, above n 3, 347.

¹⁵² See IRC § 7701(a)(4), (b) (1986 as amended).

whether the lines have been properly positioned.¹⁵³ That dispute, however, is outside the scope of this article and it leaves unaffected the basic principle that individuals substantially connected to the United States should have their net incomes taken into account in determining how the income tax will allocate the fiscal burden of the U.S. government. And, if an individual has such a connection, it seems clear that her entire net income¹⁵⁴ must be considered regardless of whether it is derived from U.S. or foreign sources.

(c) *Ability-to-Pay and Source of Income*

The source of net income is simply irrelevant to ability-to-pay.¹⁵⁵ The U.S. system of taxing the worldwide income of resident individuals is consistent with this

¹⁵³ For example, one can entertain good faith doubts about whether an individual who is present in the United States for 183 days in one year, but is never in the United States during any other year and has no ongoing U.S. ties, is properly treated by IRC § 7701(b)(3) (1986 as amended) as a U.S. tax resident for the single year during which she was physically present in the United States. See Cynthia Blum and Paula N. Singer, 'A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals', (2008) 41 *Vanderbilt Journal of Transnational Law* 705. Objections can also be raised to treating U.S. citizens as residents when they have not recently lived in the United States. See Pamela B. Gann, 'The Concept of an Independent Treaty Foreign Tax Credit' (1982) 38 *Tax Law Review* 1, 58-69. The right of return to the United States that inheres in a long-term expatriate's retained U.S. citizenship is, however, a valuable privilege, see, eg, *Cook v Tait*, 265 US 45, 56 (1924), and an expatriate's decision not to renounce U.S. citizenship can be seen as evidence that the benefits of citizenship are worth facing an annual U.S. tax on worldwide income. See generally, Michael S. Kirsch, 'Taxing Citizens in a Global Economy' (2007) 82 *New York University Law Review* 443. Such questions of whether the U.S. residency rules are overly aggressive at the margins should not, however, obscure the fact that most individual taxpayers who are treated as U.S. tax residents have sufficient U.S. connections so that the U.S. tax treatment of their total incomes must be compared to that of other U.S. residents for purposes of applying the ability-to-pay concept. With respect to the residence of corporations, see Joseph L. Andrus, 'Determining the Source of Income in a Changing World' (1997) 75 *Taxes* 839, 848.

¹⁵⁴ Fairness considerations arguably are satisfied by allowance of a deduction, as opposed to a credit, for foreign taxes. See Kaufman, above n 143, 177-78 (arguing that both the foreign tax credit and exemption approaches to mitigating international double taxation should be viewed as tax expenditures that are inconsistent with the ability-to-pay principle); see also David Gliksberg, 'The Effect of the Statist-Political Approach to International Jurisdiction of the Income Tax Regime-The Israeli Case' (1994) 15 *Michigan Journal of International Law* 459, 469. Nonetheless, as discussed further in the text at notes 211-12, we believe that the efficiency and diplomatic gains that result from allowance of a foreign tax credit to mitigate double taxation properly supercede application of the fairness criterion in addressing the double taxation issue.

¹⁵⁵ See U.S. Treas. Dep't, *Blueprints*, above n 108, 98-99; Arnold and McIntyre, above n 1, 4-6; Bradford, above n 125, 16; Ault and Bradford, above n 108, 11, 27, 31, 41; Roy Blough, 'Taxation of Income from Foreign Sources' in House Comm., *Compendium*, above n 149, 2145; Walter J. Blum, 'Tax Policy and Preferential Provisions in the Income Tax Base' in House Comm., *Compendium*, above n 149, 83-84; Gliksberg, above n 154, 468-69, 473; Green, above n 148, 29; Lawrence Lokken, 'The Sources of Income from International Uses and Dispositions of Intellectual Property' (1981) 36 *Tax Law Review* 235, 239 (hereinafter Lokken, Sources); Peggy B. Musgrave, 'Consumption Tax Proposals in an International Setting' (2000) 54 *Tax Law Review* 77, 80 (hereinafter Musgrave, Consumption Tax Proposals); Peggy B. Musgrave, 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm; A Comment' (1992) 45 *National Tax Journal* 179, 181-82; Peroni, Back to the Future, above n 68, 981 -82. For a view that an ability-to-pay "comprehensive income tax base is, at least theoretically, susceptible to division by source." see Kaufman, above n 143, 174-75.

One commentator offers a dissenting view on this point. See Klaus Vogel, 'World-wide vs. Source Taxation of Income – A Review and Reevaluation of Arguments', in *Influence of Tax Differentials in International Competitiveness* (1990) 117, 157. He argues that foreign-source income should not be taxed by a residence country until it is remitted thereto because before then, it is not enjoyed in the

conclusion;¹⁵⁶ an exemption or territorial system, under which foreign-source income is excluded from the tax base, is fundamentally inconsistent.

To illustrate this point, consider hypothetical individuals A and B who live year-round in the United States. A always earns \$8,000 of U.S.-source net income per year as a full-time convenience store clerk while B wholly owns a U.S. limited liability company (a transparent entity whose income is taxed directly to the owner or owners) which always earns \$8,000 per year of U.S.-source net income and \$10 million per year of net income sourced to active branch operations in low-tax Country X.¹⁵⁷ Under a pure territorial system, only A's and B's \$8,000 of U.S.-source income would be taken into account for income tax purposes.¹⁵⁸ Stated differently, a territorial system would allocate the fiscal burden of the U.S. government between A and B as if they had equal abilities-to-pay and both would remit the same amount of tax.

This is clearly the wrong answer.¹⁵⁹ There is nothing about foreign-source income that excuses it from being taken into account in allocating the tax burden between A and B under a tax system based on the ability-to-pay concept. A's and B's comparative abilities to pay can be properly measured only by including B's foreign-

residence country and it remains subject to investment risks in the foreign country. This argument overlooks three critical facts. First, foreign-source income reinvested offshore has an immediate wealth increase effect that enhances the taxpayer's ability-to-pay out of residence country resources. Second, where significant currency controls or other foreign law restrictions prevent the all-events test from being satisfied with respect to foreign-source income of accrual method taxpayers, or prevent the receipt requirement from being satisfied with respect to foreign-source income of cash method taxpayers, the taxpayers will be relieved from recognizing the affected income by the ordinary operation of the U.S. tax system. See, *eg*, Treasury Regulation § 1.451-1(a). If this is not regarded as an adequate remedy for the problem of foreign legal barriers to income repatriation, consideration could be given to a narrowly focused provision that defers inclusion of the income for as long as it is subject to such restrictions. See IRC § 964(b) (1986 as amended). Third, the investment risk objection is relevant to ability-to-pay only if the risk resolves adversely and a loss actually occurs. If this happens, the proper response by the tax system is to allow the taxpayer a deduction when the loss is sustained, provided that the loss represents income that was previously included in gross income under the taxpayer's accounting method.

The exercise of taxing jurisdiction over the foreign-source income of residents is clearly acceptable under international norms. See, *eg*, American Law Institute, *Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons* (1986) 4-6; American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States* (1987) § 412(l)(a); Ault and Arnold, *above n 3*, 345; Gustafson, Peroni and Pugh, *above n 1*, 14-15.

¹⁵⁶ See Peroni, *Back to the Future*, *above n 68*, 981-82. The U.S. view is expressed in IRC § 61 (a) (1986 as amended), which defines gross income as "all income from whatever source derived."

¹⁵⁷ A might also receive government transfer payments, including an earned income tax credit, that should be taken into account for purposes of determining whether the allocation of the tax burden between A and B properly reflects their comparative abilities-to-pay. See U.S. Treas. Dept. *Distributional Analysis*, *above n 125*, § 5.1; J. Clifton Fleming, Jr., 'Renewing Progressive Taxation by Relying More on Spending' (1993) 60 *Tax Notes* 802; Barbara H. Fried, 'The Puzzling Case for Proportionate Taxation' (1999) 2 *Chapman Law Review* 157, 182-83. Transfer payments would, however, have little effect on the differences between A's and B's ability-to-pay and they are left out of the analysis to simplify it.

¹⁵⁸ See Gustafson, Peroni and Pugh, *above n 1*, 19; See also Palmer, *above n 148*, 15 ("a home country's exemption of income earned through a foreign economic relationship presents greater problems in effectuating the fairness doctrine than does a properly designed foreign tax credit regime").

¹⁵⁹ Because B's income is vastly larger than A's, the ability-to-pay fairness concept clearly would be violated by a U.S. territorial system that imposed identical tax liabilities on A and B. This conclusion is sufficient for our purposes; there is no need to analyze the A-B example in terms of vertical and horizontal equity. However, if other observers would prefer to describe equal taxation of A and B in this example as a violation of the principle of vertical equity, we have no quarrel with their doing so. See, *eg*, OECD, *Tax Effects*, *above n 5*, 95; Avi-Yonah, *Globalization*, *above n 101*, 1616.

source net income in the calculus.¹⁶⁰ Current law accomplishes this result by ignoring the LLC for tax purposes, treating the LLC's entire net income as taxable to B¹⁶¹ and imposing a much larger tax on B than on A.¹⁶²

(d) *Compared to Whom?*

One could argue that if individual C is an X Country resident who also earns \$10,000,000 of X Country-source business income and pays the low X Country rate thereon, fairness requires the A-B comparison to be replaced with a B-C comparison and requires that B's \$10,000,000 X Country-source income be exempted from the U.S. tax base so that this income bears only the low X Country tax paid by C.¹⁶³ If, however, the U.S. Congress decides to tax U.S. residents' entire taxable incomes at a high rate (with a credit for foreign taxes) and Country X decides to impose tax at a low rate on its residents and on income sourced within its borders, there is no fairness-based reason why the level of X Country source-based taxation should dictate the U.S. conception of fairness with respect to U.S. residents. Each country has the right to decide the notions of tax fairness that will prevail with respect to members of its society.¹⁶⁴ Moreover, if X Country's tax rate on B's and C's Country X-source income

¹⁶⁰ See authorities cited in above n 155. Although this conclusion is sometimes justified as necessary to prevent avoidance of the individual income tax's progressive rate structure, See U.S. Treas. Dep't, *Blueprints*, above n 108, 99; Vito Tanzi, *Taxation in an Integrating World*, 77-78 (1995); Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 *Texas Law Review* 1301, 1311-12; Lee Burns and Richard Krever, 'Individual Income Tax' in Victor Thoronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, 495,496-97; Graetz, *Outdated Concepts*, above n 47, 333; Green, above n 148, 29; Julie Roin, 'Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems' (1995) 81 *Virginia Law Review* 1753, 1761 (hereinafter Roin, *Rethinking*); 'Introduction' in Victor Thoronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, xxi-xxiii, the conclusion is fully applicable to a single-rate income tax, See Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (1953) xvii; See also below n 162. Many of those who prefer to subdivide the ability-to-pay concept into horizontal and vertical equity components would argue that including B's foreign-source income in the tax base is necessary to satisfy both components irrespective of concerns about progressivity.

¹⁶¹ See Treasury Regulation §§ 301.7701-3(a), (b)(1)(ii). There are narrow exceptions to this general approach of imposing worldwide taxation on U.S. residents. See, eg, IRC § 911 (1986 as amended) (exclusion of a limited amount of foreign earned income and certain qualified housing amounts).

¹⁶² See generally IRC § 1 (1986 as amended).

The current Internal Revenue Code imposes progressive rates on the incomes of individuals (and on corporations as well, see IRC § 11) (1986 as amended). Although we are supporters of this approach (at least with respect to individuals) we have chosen to defer our advocacy in behalf of progression. Thus, in this article when we assert that B's \$10 million of foreign-source net income should be included in her U.S. taxable income and that she should pay a larger tax than A, we are saying nothing about what the rate of should be on A's \$8,000 of net income or whether any part of B's income should be taxed at a rate higher than the rate applicable to A's net income. Stated differently, in this article, we do not, and need not, enter the debate over whether tax rates are too low or too high, or the debate regarding whether the income tax should be progressive and if so, how progressive. Instead, we limit ourselves to arguing that because B's income is 1,251 times larger than A's, B should pay a tax that is at least 1,251 times larger than the amount paid by A.

For a sampling of the rich literature on the progressive taxation controversy, see Blum and Kalven, above n 160; McMahon and Abreu, above n 148.

¹⁶³ See generally Klaus Vogel, 'The Search for Compatible Tax Systems', in Herbert Stein (ed) *Tax Policy in the Twenty-First Century* (1988) 76, 85; Vogel, above n 155, 156-57.

¹⁶⁴ See American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States* (1987) §§ 411-413; Commission of the European Communities, *Tax Policy in the European Union-Priorities for the Years Ahead* (2001) 9, 25; Avi-Yonah, *Globalization*, above n 101, 1629; Graetz, *Outdated Concepts*, above n 47, 277-282; Julie Roin, 'Competition and Evasion: Another Perspective

were higher than the U.S. rate on B's Country X-source income, it would be difficult to find advocates for the view that the B-C comparison compels the United States to raise its rate on B's Country X income up to the Country X rate (so that B would not have any X Country tax in excess of the U.S. credit that could be cross-credited against low foreign taxes on other income or carried back to a prior year or forward to future years).¹⁶⁵

3 What if Everybody Can Do It?

(a) A Self-Inflicted Wound?

Assume that the United States has adopted an exemption system and that U.S. residents E and F each has sufficient capital to invest in a business that will produce before-tax net income of \$10 million per year. Assume further that all U.S. residents have ready access to foreign investment opportunities. E chooses to acquire a business in low-tax Country X. Therefore, he pays no U.S. tax on his \$10 million of Country X-source income. F could do the same as E but, instead, she acquires a U.S. business. As a result, she pays U.S. tax on her \$10 million of U.S.-source income. Some analysts would argue that this disparate treatment of E and F does not contravene the ability-to-pay principle. This is because we are assuming that F had an equal opportunity to make a Country X investment annually yielding \$10 million of foreign-source net income. Under this assumption, the fact that the United States imposes a heavier tax on F's U.S.-source income of \$10 million than on E's foreign-source income of the same amount is due entirely to F's affirmative choice to earn U.S.-source income instead of exempt Country X-source income. Thus, some commentators would argue that although this hypothetical exemption system is a poorly designed tax expenditure that improperly encouraged E to make a foreign investment that may be economically inferior, F is the victim of a "self-inflicted wound"¹⁶⁶ and is not suffering from a violation of the ability-to-pay norm.¹⁶⁷

We disagree with this argument because it is impractical to measure ability-to-pay in terms of forgone opportunities. The only feasible way of comparing the abilities-to-pay of separate taxpayers is by looking at their *actual incomes* from all sources.¹⁶⁸

on International Tax Competition' (2001) 89 *Georgetown Law Journal* 543, 597 (hereinafter Roin, Competition); Stanley S. Surrey, 'Current Issues in the Taxation of Corporate Foreign Investment' (1956) 56 *Columbia Law Review* 815, 824; Alvin C. Warren, Jr, 'Alternatives for International Corporate Tax Reform' (1994) 49 *Tax Law Review* 599,612; See also Dan R. Mastromarco, 'Department of Treasury Exercises Good Judgment on OECD Initiative' (2001) 91 *Tax Notes* 1623, 1624; Daniel J. Mitchell, 'OECD Tax Competition Proposal: Higher Taxes and Less Privacy' (2000) 89 *Tax Notes* 801, 814-15; U.S. Treasury Secretary Statement on OECD Tax Havens (2001) 22 *Tax Notes International* 2617; Letter from Congressman Dick Armey to Secretary of the Treasury Lawrence Summers (Sept.7, 2000), reprinted in (2000) 88 *Tax Notes* 1539, 1540.

¹⁶⁵ See Mitchell, above n 164, 803-06, 814-15, 821-22; Surrey, above n 164, 825 ("when all of the recommendations of these organizations for eliminating double taxation are added up, the basic jurisdictional rule they suggest is not that of the country of citizenship and not that of the country of source, but rather that of the country with the lowest tax rate.").

¹⁶⁶ Boris I. Bittker, 'Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?' (1979) 16 *San Diego Law Review* 735, 739.

¹⁶⁷ See Ault and Bradford, above n 108, 29-30; Zolt, above n 149, 91-92.

¹⁶⁸ See U.S. Treas. Dep't, *Blueprints*, above n 108, 3, 159-62; U.S. Treas. Dep't, *Tax Reform*, above n 147, 14-15, 37-42; Blum and Kalven, above n 160, 64; Bradford, above n 146, 16-19, 155-56. See also Dodge, *Theories*, above n 148, 449 (arguing for taking an objective approach when defining ability-to-pay).

Thus, the predominant approach to measuring ability-to-pay would regard the disparate U.S. taxation of E's and F's equal incomes as violating the ability-to-pay concept.

A more fundamental problem with this "self-inflicted wound" analysis, however, arises from its critical assumption that opportunities to earn foreign-source business income are freely and equally available to all U.S. residents. This is plainly not correct. There are barriers of distance, language, custom and unfamiliar and complex legal regimes that exclude numerous U.S. residents from the opportunity to earn foreign-source business income with anything approaching the foreign income earning facility of other U.S. residents. Consequently, the assumption in the preceding example of equal access to foreign-source income is unrealistic and in the real world, the fact that F pays a heavier U.S. tax on her income than does E cannot necessarily be dismissed as a result of F's bad judgment. This point is especially important with respect to labor income. The wage income that dominates the earnings of most individual taxpayers is far less mobile than other business income. Indeed, most of the international income earned by U.S. residents is from capital – either direct or portfolio investment of capital.¹⁶⁹ Thus, the key premise of the preceding discussion, equal opportunity to earn foreign-source business income, does not really exist so long as there are disparities in wealth among taxpayers that result in some U.S. residents being able to earn foreign-source income from investing mobile capital while many more U.S. residents are effectively limited to earning relatively immobile wage income from U.S. sources.

(b) Portfolio Investment as a Possible Answer

Some would point out at this juncture that although A and F might not have a ready opportunity to earn foreign-source business income from foreign direct investment, there are abundant opportunities for U.S. residents to earn foreign-source portfolio income by purchasing shares in foreign companies and by investing in mutual funds that buy foreign securities.¹⁷⁰ This point is not responsive, however, because the advocates of a U.S. exemption system do not ordinarily contemplate that the system would cover foreign-source passive income.¹⁷¹ This reluctance is probably due to the fact that a generally available zero U.S. rate for offshore passive income would be seen as inconsistent with a fundamental feature of an income tax, as opposed to a consumption tax, namely, that income from capital should be taxed.¹⁷² Moreover, the exemption of foreign-source portfolio investment income from U.S. taxation would

¹⁶⁹ For 1998, aggregate U.S. income receipts on non-government U.S. assets owned abroad were \$252,247,000,000, while employee compensation earned abroad by Americans was \$1,857,000,000. See United States Department of Commerce, *Statistical Abstract of the United States* (1999) 790; See also Avi-Yonah, *Globalization*, above n 101, 1617-18; Green, above n 148, 60.

¹⁷⁰ See Ault and Bradford, above n 108, 29-30.

¹⁷¹ U.S. Treas. Dep't, *Approaches*, above n 2, 54-63; Advisory Panel, *Proposals*, above n 18, 134. Indeed, countries that have adopted exemption systems have typically excluded foreign-source portfolio income from their exemption regimes. See Ault and Arnold, above n 3, 372-73.

¹⁷² See Dodge, Fleming and Geier, above n 147, 138-49; Grubert and Newlon, above n 10, 623 ("[I]ncome from passive, or portfolio, foreign investment could not realistically be exempted without leading to substantial erosion of the taxation of capital income"); Stephen E. Shay and Victoria P. Summers, 'Selected International Aspects of Fundamental Tax Reform Proposals' (1997) 51 *University of Miami Law Review* 1029, 1032-33.

likely encourage U.S. residents to effect a large shift of passive investments from the United States to low- or zero-tax rate foreign jurisdictions.¹⁷³

(c) Implicit Taxes as a Possible Answer

But suppose the exemption system adopted by the United States causes internationally sophisticated U.S. residents to engage in so much direct investment in Country X that the before-tax rate of return on B's active business investments in Country X is driven down to a point where B's after-tax return on those investments equals the after-tax rate of return available to A on U.S. investments. Exemption system advocates could argue that the ability-to-pay objection to the hypothetical U.S. exemption system has been eliminated because B is now paying an implicit tax¹⁷⁴ on her Country X income, in the form of a decreased before-tax rate of return, that results in her greater income bearing a larger aggregate tax than A's smaller income.

The problem with this line of argument is that implicit taxes are not collected by governments. Thus, the implicit tax paid by B, in the form of a lower before-tax rate of return on her Country X investment, does not go to the U.S. Treasury and, therefore, it does nothing to increase the portion of the cost of the U.S. government borne by B vis-a-vis A. Stated differently, the implicit tax borne by B fails to correct the misallocation of the U.S. tax burden that exists between A and B if A pays the same amount of U.S. tax as B. Nor does the implicit tax go to the Country X Treasury where it would support a claim by B against the United States for double taxation relief.¹⁷⁵ In short, the implicit tax suffered by B does not solve the ability-to-pay objection to the hypothetical U.S. exemption system. Thus, there seem to be no market dynamics undermining the critical observation that the ability-to-pay principle requires B's larger income to bear a greater U.S. tax than A's smaller income and that an exemption system produces a contrary result.

¹⁷³ Of course, many types of modern business income are also quite mobile and that is one key reason why an exemption system for foreign business income would likely lead to tax-motivated business investment in low-tax foreign countries. See U.S. Treas. Dep't, *Deferral*, above n 47, 44-45, 182-84, 197-209.

¹⁷⁴ For explanations of implicit taxes, see U.S. Treas. Dep't, *Blueprints*, above n 108, 152-53; George Cooper, 'The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance' (1985) 85 *Columbia Law Review* 657, 698-99; Fleming and Peroni, *Tax Expenditure Analysis*, above n 10, 446-47, 461-68; Harvey Galper and Dennis Zimmerman, 'Preferential Taxation and Portfolio Choice: Some Empirical Evidence' (1977) 30 *National Tax Journal* 387, 388; Calvin H. Johnson, 'Inefficiency Does Not Drive Out Inequity: Market Equilibrium and Tax Shelters' (1996) 71 *Tax Notes* 377, 381-82; Stanley S. Surrey and Paul R. McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974' (1976) 17 *Boston College Industrial and Commercial Law Review* 679, 702-06; Edward Yorio, 'Equity, Efficiency, and the Tax Reform Act of 1986' (1987) 55 *Fordham Law Review* 395, 397-400. On these facts, of course, the exemption system produces an inefficient result in the sense that it induces U.S. residents to over-invest in Country X. See Altshuler, above n 101, 1581; Avi-Yonah, *Globalization*, above n 101, 1604-05; Zolt, above n 149, 92.

¹⁷⁵ Moreover, it is doubtful that the flow of direct investment capital into low-tax foreign countries would be sufficient to result in a convergence of after-tax rates of return. See NFTC, *International Tax Policy*, above n 72, 116. With respect to the failure of after-tax rates of return on tax exempt municipal bonds and taxable bonds to converge, see Johnson, above n 174, 377. But see Hines, *Reconsidering*, above n 72, 34 (arguing that implicit taxes redress fairness concerns even if the implicit taxes inure entirely to the benefit of non-governmental parties).

4 U.S. Corporations and Ability-to-Pay¹⁷⁶

(a) *The Need for an Anti-Deferral Device*

Some commentators apparently concede that the preceding analysis establishes a persuasive case for worldwide taxation of U.S. resident individuals but, nevertheless, they are attracted to U.S. exemption treatment for the foreign-source income of U.S. resident C corporations.¹⁷⁷ (In U.S. federal income tax law, a C corporation is a company that is subjected to a corporate-level income tax and whose income is not taxed to its shareholders until distributed as dividends.) This raises the question of whether the preceding ability-to-pay analysis is applicable to income earned through C corporations.

A useful way to pursue an answer is to revisit the preceding example in which U.S. resident individual B owns a U.S. LLC earning \$8,000 per year of U.S.-source net income and \$10 million per year of active business net income in low-tax Country X. Now assume that B converts her wholly owned LLC into a U.S. C corporation named USCo. B then sells half of her new USCo stock in a public offering to 10,000 residents of Country X and donates the stock sales proceeds to her favorite law school as an endowment for a tax law chair. Thereafter, the shares of USCo are traded on an established securities market. On these facts, B's amounts of U.S.-source and foreign-source income are reduced by half to \$4,000 and \$5 million respectively (she owns only 50% of the USCo stock), but both amounts should be taken into account for U.S. income tax purposes in measuring B's ability to pay vis-a-vis low-income A. This result would be achieved directly if C corporation income were taxed to shareholders under a pass-through integration regime based on the principles of Subchapter K or S.¹⁷⁸ This is not, however, the way that the United States generally taxes C corporations. The income of a U.S. C corporation¹⁷⁹ is typically subjected to both a corporate-level tax as it is earned by the corporation and also to a shareholder-level tax at the, perhaps distant, time when the shareholders receive the income from the corporation or sell their shares.¹⁸⁰

¹⁷⁶ For the sake of simplicity, we assume throughout the remainder of this article that all shareholders are individuals unless otherwise stated. Thus, we reserve for a future article a discussion of the extent to which look-through rules are appropriate where stock is owned by juridical entities.

¹⁷⁷ See Herman B. Bouma, 'Further Support for Territorial Taxation' (2000) 87 *Tax Notes* 580; Graetz, Outdated Concepts, above n 47, 325-31, 333-35; Tuerff, Shaviro, Shackelford, McDonald and Mundaca, above n 11, 76-78.

¹⁷⁸ See IRC §§ 702(a), 1366(a) (1986 as amended); Jeffrey L. Kwall, 'The Uncertain Case Against the Double Taxation of Corporate Income' (1990) 68 *North Carolina Law Review* 613, 629. For a description of such an integration scheme, see U.S. Treas. Dep't *Blueprints*, above n 108, 69-73, 98-100. Some of the most prominent recent integration proposals have, however, regarded this approach to integration as unfeasible and have advocated schemes that rely on a corporate-level tax. See United States Treasury Department, *Integration of the Individual and Corporate Tax Systems* (1992) 39-49 (hereinafter U. S. Treas. Dep't, *Integration*); American Law Institute, *Integration of the Individual and Corporate Income Taxes* (1993) 92-94 (hereinafter American Law Institute, *Integration*).

¹⁷⁹ In the example in the text, the number of shareholders and the nonresident alien status of 10,000 of them will prevent taxpayer B from using a Subchapter S election to get her corporation out of C status. See IRC § 1361(b)(1) (1986 as amended). Moreover, if B had forgone conversion of her LLC to a C corporation and had, instead, sold half her interest in profits and capital to 10,000 investors, the probable public trading in the ownership interests of taxpayer B's LLC would prevent the LLC owners from avoiding C status by failing to formally incorporate the LLC. See IRC § 7704 (1986 as amended) and assume that IRC § 7704(c) (1986 as amended) is inapplicable.

¹⁸⁰ See IRC §§ 11, 61(a)(3), (7) (1986 as amended). The shareholder-level tax is not reduced by credits reflecting corporate-level tax. Thus, the corporate-level and shareholder-level income taxes function as

This taxation scheme cannot be explained on ability-to-pay grounds because liability under the corporate-level tax is calibrated to the taxable income of the corporation and bears no necessary relationship to the respective abilities to pay of any individuals.¹⁸¹ Thus, several rationales other than ability-to-pay have been proposed as justifications for the corporate-level tax and there is disagreement regarding which of these is the "best" and, indeed, whether the basic concept of a separate, unintegrated corporate income tax is defensible at all.¹⁸² The merits of this controversy are outside the scope of this article. More importantly, in spite of this dispute over the theoretical justification for a separate, unintegrated tax on corporate income, there is broad agreement that because pass-through treatment cannot be practically imposed on corporations with large numbers of shareholders¹⁸³ and because Congress is quite unlikely, in the near term, to adopt other means of currently taxing shareholders on corporate income through integration of the corporate and individual income taxes, the present corporate-level tax must be maintained as a crude, second-best anti-deferral device.¹⁸⁴ Otherwise, C corporation shareholders

independent, cumulative levies. This article assumes that this classical double taxation of C corporation income will continue as the general pattern under the Internal Revenue Code for the foreseeable future even though we believe that integration of the corporate and shareholder income taxes would be a desirable policy move.

Double taxation is avoided in the cases of domestic C corporations reporting their income with a parent corporation on a consolidated return, see IRC §§ 1501-1504 (1986 as amended), and certain wholly owned domestic subsidiaries of S corporations, see IRC § 1361(b)(3) (1986 as amended).

¹⁸¹ See IRC § 11(a), (b)(1); M. Slade Kendrick, 'Corporate Income Tax Rate Structure' in House Comm., *Compendium*, above n 149, at 2289, 2297; Yin, *The Future*, above n 146, 152. Because the corporate-level tax is generally regarded as borne by living taxpayers and not the entity itself, the question of a C corporation's ability-to-pay is commonly viewed as irrelevant. See U.S. Treas. Dep't, *Blueprints*, above n 108, 4; Graetz, *Outdated Concepts*, above n 47, 301-02; See also Katherine Pratt, 'The Debt-Equity Distinction in a Second-Best World' (2000) 53 *Vanderbilt Law Review* 1055, 1113-14.

¹⁸² See Calvin H. Johnson, 'Replace the Corporate Tax with a Market Capitalization Tax' (2007) 117 *Tax Notes* 1082; American Law Institute, *Integration*, above n 178, 44-46; American Law Institute, *Taxation of Private Business Enterprises* (1999) 51-55, 59-63; Bradford, above n 146, 103; Jeffrey A. Maine, 'Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises' (2000) 62 *University of Pittsburgh Law Review* 223, 241-44, 253-57; Pratt, above n 181, 1100-03, 1109-10. With respect to the historical origins of the corporate-level tax, see Stephen A. Bank, 'Entity Theory as Myth in the Origins of the Corporate Income Tax' (2001) 43 *William and Mary Law Review* 447; Majorie E. Kornhauser, 'Corporate Regulation and the Origins of the Corporate Income Tax' (1990) 66 *Indiana Law Journal* 53.

¹⁸³ See Graeme S. Cooper and Richard K. Gordon, 'Taxation of Enterprises and Their Owners' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, 811, 817; Pratt, above n 181, 1112-13; George K. Yin, 'Corporate Tax Integration and the Search for the Pragmatic Ideal' (1992) 47 *Tax Law Review* 431, 434 (1992) (hereinafter Yin, *Ideal*); see also U.S. Treas. Dep't, *Integration*, above n 178, 27-35. Among other things, large numbers of shareholders imply frequent trading in a corporation's stock which creates difficulties in allocating income and losses to the shareholders. For contrary views asserting that a pass-through system can be constructed for corporations with large numbers of shareholders, see U.S. Treas. Dep't, *Blueprints*, above n 108, 69-74; Yin, *The Future*, above n 146, 195-96.

¹⁸⁴ See OECD, *Tax Effects*, above n 5, 95-96; U.S. Treas. Dep't, *Integration*, above n 178, 189 n.1; U.S. Treas. Dep't, *Tax Reform*, above n 147, 118-21; J.D.R. Adams and J. Whalley, *The International Taxation of Multinational Enterprises in Developed Countries* (1977) 8; American Law Institute, *Integration*, above n 178, 94; Bradford, above n 146, 55; Jane G. Gravelle and Thomas L. Hungerford, *Congressional Research Service Report for Congress, Corporate Tax Reform: Issues for Congress* (2007) 4; Joseph A. Pechman, *Federal Tax Policy* (5th ed. 1987) 136; Slemrod and Bakija, above n 141, 275; Ault and Bradford, above n 108, 37; Cooper and Gordon, above n 183, 812-13; Malcolm Gammie, 'The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement' (1994) 49 *Tax Law Review* 615, 628-29; Graetz, *Outdated Concepts*, above n 47, 302;

would be able to completely defer taxation until they withdrew the corporations' earnings (or sold their shares), thus achieving a deferral of U.S. tax that is not available to the owners of closely held businesses¹⁸⁵ taxed under the Subchapter K or S pass-through regimes. Indeed, we believe that the anti-deferral effect of the present U.S. corporate income tax is the only persuasive reason for a large, unintegrated levy on corporate earnings.

(b) The Overbreadth of the Corporate Income Tax

The corporate-level income tax, however, is indeed a crude anti-deferral instrument for three reasons. First, its rates (15% to 35%) bear no direct relationship to the length of time that the shareholder-level tax is deferred. Thus, the corporate-level tax is usually either greater than, or less than, the amount necessary to offset the economic benefit gained from deferring the shareholder-level tax. Second, the corporate-level tax in the preceding example may be partially shifted to investors in the noncorporate sector and to USCo's customers and suppliers of materials and labor,¹⁸⁶ none of whom are engaged in deferring shareholder-level tax on shares of USCo's income.¹⁸⁷ Finally, USCo may satisfy the 80% active foreign business requirement of Sections 871(i)(2)(B) and 881(d) so that the part of the dividends received by USCo's foreign shareholders that is proportionate to the corporation's foreign-source gross income would be exempt from U.S. tax.¹⁸⁸ To that extent, the foreign shareholders are not engaging in deferral of investor-level tax with respect to USCo's income and they are not proper targets of the corporate-level anti-deferral regime. Moreover, a pass-through tax regime modeled on Subchapter K would relieve the foreign shareholders from paying tax on the \$5 million of USCo's foreign-source net income that is attributable to them.¹⁸⁹ Therefore, it is inappropriate to apply a corporate-level anti-deferral tax to that income even if USCo does not satisfy the 80% foreign business

Kwall, above n 178, 629-30; see also U.S. Treas. Dep't, *Deferral*, above n 47, 4; Utz, above n 148, 177-78; Pratt, above n 181, 1115; Rebecca S. Rudnick, 'Who Should Pay the Corporate Tax in a Flat Tax World' (1988-89) 39 *Case Western Reserve Law Review* 965, 1066-69; Joseph A. Snoe, 'The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distribution Tax' (1993) 48 *University of Miami Law Review* 1, 43; David A. Weisbach, 'The Irreducible Complexity of Firm-Level Income Taxes' (2007) 60 *Tax Law Review* 215, 217.

Of course, if the corporate-level tax were integrated with the shareholder-level tax, the corporate-level tax could continue to serve its anti-deferral function without imposing the double tax result that characterizes the present approach to taxing C corporations. There is, however, no near-term likelihood of such an integration scheme being adopted in the U.S. and this article assumes continuation of the current regime of C corporation taxation, no matter how ill-advised that may be from a tax policy standpoint.

¹⁸⁵ Generally speaking, only closely held businesses can qualify for the Subchapter K or S passthrough regimes.

¹⁸⁶ See U.S. Treas. Dep't, *Blueprints*, above n 108, 4-5; U.S. Treas. Dept, *Distributional Analysis*, above n 146, § 6.4; U.S. Treas. Dep't, *Integration*, above n 178, 146-47; William M. Gentry, *United States Treasury Department Office of Tax Analysis Paper 101, A Review of the Evidence on the Incidence of the Corporate Income Tax* (2007) <<http://www.ustreas.gov/offices/tax-policy/library/ota101.pdf>>; Bradford, above n 146, 136-39; Slemrod and Bakija, above n 141, 76-77; William A. Klein, 'The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics', 1965 *Wisconsin Law Review* 576; Pratt, above n 181, 1108; Roin, *Competition*, above n 164, 576-77.

¹⁸⁷ See Kwall, above n 178, 635 n.115.

¹⁸⁸ See IRC §§ 861(c), 871 (i), 881 (d) (1986 as amended).

¹⁸⁹ See IRC §§ 871, 881 (1986 as amended); Treasury Regulation § 1.1441-5(b)(2)(i); Rev. Proc. 89-31, 1989-1 C.B. 895.

requirement. Nevertheless, under current law the foreign shareholders' entire portion of USCo's income bears U.S. corporate-level tax to the extent that the tax burden is not shifted to others.

We should note, however, that the first two of these criticisms (the lack of relationship between the corporate-level tax rates and the deferral period and the partial shifting of the corporate-level tax) apply even if a C corporation's income is entirely from U.S. sources. Only the third criticism (that the corporate-level tax reaches foreign stockholders' shares of foreign-source corporate income) is directly relevant to the issue of whether a U.S. corporation's foreign-source income is properly subject to the corporate-level tax. Moreover, the cure for this third criticism (as well as the first two) lies in the United States adopting a responsive integration system. Thus, the imprecision of the corporate-level tax does not present a case for exempting the foreign-source income of U.S. C corporations.¹⁹⁰ Instead it presents a case for a corporate integration regime that would (1) relieve foreign shareholders of U.S. tax on their portion of corporate foreign-source income, but (2) also uphold the ability-to-pay principle by imposing current U.S. tax on all corporate income (foreign-source as well as U.S.-source) attributable to U.S. resident shareholders.¹⁹¹

(c) Searching for the Lesser Evil

Unfortunately, the United States has not adopted the necessary integration scheme and is unlikely to do so in the near future. Thus, the federal income tax system continues to require a corporate-level tax that functions as a second-best anti-deferral device. This means that although exempting foreign-source income of U.S. C corporations from the corporate-level tax would cure the over breadth of that tax with respect to foreign-source income attributable to foreign shareholders, it would do so at the cost of allowing U.S. stockholders to substantially remove their shares of corporate foreign-source income from the U.S. tax base by causing U.S. C corporations to defer distributions until the present value of the shareholder-level tax shrinks to insignificance.¹⁹² This would effectively defeat the ability-to-pay principle, which requires that both U.S.-source and foreign-source income be included in determining a U.S. resident's appropriate share of the expense of government. Stated more broadly, granting exemption from the corporate-level tax for all foreign-source income of U.S. C corporations would allow U.S. resident individuals to escape the

¹⁹⁰ See also U.S. Treas. Dep't, *Deferral*, above n 47, 35; Avi-Yonah, *Globalization*, above n 101, 1609.

¹⁹¹ For a description of such an integration regime, See U.S. Treas. Dep't, *Blueprints*, above n 108, 69-73, 98-100.

¹⁹² Neither the U.S. domestic nor international anti-deferral regimes are serious threats to this tax planning approach. See generally Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed, 2000) ch. 7; Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation* (5th ed, 1992) vol 1, chs. B2, B3; Peroni, Fleming and Shay, *Getting Serious*, above n 20, 460-64. Moreover, as discussed recently by the U.S. Treasury Department, exempting a C corporation's foreign-source income from U.S. tax while maintaining an entity-level tax on U.S.-source income would distort investment behavior by corporations:

[R]educing only the tax on foreign investment income would cause domestic corporate investors to favor a foreign investment over a domestic alternative that has a higher pretax return. The tax bias against corporate investment [because of the U.S. double tax regime], by itself, does not provide a compelling reason to favor foreign or domestic corporate investments if the overall goal is to minimize distortions in investment decision.

U.S. Treas. Dept, *Deferral*, above n 47, 35. In other words, the appropriate solution to the overbreadth problem of the U.S. corporate tax is not lowering or eliminating the tax on only foreign-source income.

inclusionary requirement of the ability-to-pay principle by interposing a U.S. C corporation between themselves and their foreign-source income. By contrast, maintaining an unintegrated corporate-level tax on the worldwide income of U.S. C corporations would uphold the ability-to-pay principle with respect to U.S. shareholders but, as explained above,¹⁹³ would incorrectly tax the portion of the foreign-source income of U.S. C corporations that is attributable to foreign shareholders.

This difficult dilemma should be resolved in favor of sustaining the ability-to-pay principle with respect to U.S. shareholders by imposing U.S. corporate-level tax on the foreign-source income of U.S. corporations regardless of the presence of foreign shareholders. This is burdensome to the foreign shareholders but not unfair because the corporate-level tax is a clearly disclosed element of the U.S. tax system and nonresidents purchase the shares of U.S. corporations with their eyes wide open.¹⁹⁴

(d) Defining Corporate Residence and Pursuing Runaway Corporations and Shareholders

In the preceding discussion, we have referred to corporations taxed by the United States on their worldwide incomes as “U.S. corporations” and “U.S. C corporations” without further explanation. We recognize that in taking this approach, we have oversimplified matters by acting as if the identification of such corporations were an obvious, non-controversial matter. We did so because this is, in fact, a difficult and complex issue and a thorough analysis would substantially detract from our focus on the international implications of the ability-to-pay principle. Nevertheless, the problem of identifying the corporations that should be subjected to U.S. taxation of their worldwide incomes has important implications regarding the ability-to-pay principle and a brief discussion is appropriate at this point.

A corporation is treated as a U.S. resident, taxed by the United States on its worldwide income, if it satisfies the Internal Revenue Code's definition of a “domestic corporation”—i.e., if it is incorporated under the laws of the United States, one of the 50 states or the District of Columbia.¹⁹⁵ Commentators have argued that when this place-of-incorporation rule is coupled with the U. S. worldwide taxation system, it creates the indefensible possibility of a corporation with no U.S. shareholders, no U.S. assets and no U.S.-source income incurring U.S. tax on its foreign-source income merely because it was incorporated in a U.S. jurisdiction.¹⁹⁶

We recognize that when U.S. resident status is bestowed on a corporation owned exclusively by foreign shareholders and earning its income entirely outside the United States, the result is overtaxation of the foreign shareholders by the United States. We do not view this as a significant practical problem, however, because the universe of

¹⁹³ See text accompanying above n 186-91.

¹⁹⁴ This issue was presented in 1876 to the Exchequer Court under the British regime which taxed the worldwide income of British resident corporations. In upholding the imposition of this tax on the foreign-source income of a British resident corporation whose shares were owned primarily by nonresidents, Chief Baron Kelly stated, “that if a foreigner residing abroad ... thinks fit to come and invest his money in this country, and so to obtain the broad shield of protection of the law to his property, he must take it with the burdens belonging to it.” *Calcutta Jute Mills Co v Nicholson and Cesena Sulphur Co v Nicholson*, (1876) 1 Reports of Tax Cases 83, 88,102.

¹⁹⁵ IRC §§ 11, 7701(a)(4), (5) (1986 as amended).

¹⁹⁶ See Herman B. Bouma, ‘Two Arguments Against an Alternative View of Deferral’ (2000) 20 *Tax Notes International* 875; H. David Rosenbloom, ‘The David R. Tillinghast Lecture: International Tax Arbitrage and the “International Tax System”’ (2000) 53 *Tax Law Review* 137, 139.

domestic corporations with no U.S. shareholders, no U.S. assets and no U.S.-source income is surely very small and nearly always the result of informed planning.¹⁹⁷

A related suggestion has been made that the combination of the U.S. approach to defining corporate residency and the U.S. system of worldwide taxation will drive U.S. resident corporations to incorporate their new ventures (say Intel's development of its next-generation processor) in low-tax offshore jurisdictions.¹⁹⁸ The new corporations would then be foreign residents that escape current U.S. taxation of their foreign-source income. However, if runaway corporations are truly a threat to the U.S. income tax base, the problem can be properly addressed by expanding the definition of "domestic corporation." To be specific, if U.S. resident corporations incorporate their new product developments offshore, the United States could counter that tax-avoidance strategy by enlarging the definition of "domestic corporation" to include entities whose stock is held in significant percentages by U.S. residents.¹⁹⁹ Even better, the United States could totally end deferral of U.S. tax on income earned by U.S. shareholders through foreign corporations by applying a pass-through regime to such income.²⁰⁰

More importantly, the concept of corporate residence is critical to a system of worldwide taxation because only residents are taxed by their residence country on their worldwide incomes. Recently, Professor Michael Graetz has cast doubt on whether any definition of corporate residence, including the stock ownership approach suggested immediately above, is defensible or practical. His specific statements are:

[I]n the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied with legal niceties....²⁰¹

...

It is precarious to turn significant U.S. tax consequences on the status of a corporation as a resident or nonresident, given the difficulty of assessing the "true" residence of corporations, except in the case of closely-held companies where the residence of the owners easily can be determined. Linking corporate residence to the residence of its owners simply does not seem practical in the context of multitiered multinationals. On the other hand, insisting that a corporation's residence is the same as that of its managers or officers seems difficult to justify.²⁰²

Professor Graetz uses these assertions regarding the difficulty of formulating a defensible and feasible definition of corporate residence as an element in constructing a case for seriously considering exemption treatment of corporate foreign-source income by the United States.²⁰³ We agree that any definition of corporate residence is inevitably artificial because corporations themselves are artificial beings. But as

¹⁹⁷ See Joel Slemrod, 'The Taxation of Foreign Direct Investment: Operational and Policy Perspectives' in James M. Poterba (ed), *Borderline Case* (1997) 11, 31. For example, towards the end of the boom in technology stocks, Israeli technology start-up companies were routinely formed as U.S. corporations in anticipation of issuing Nasdaq-traded stock in the United States.

¹⁹⁸ See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 1, 8-9, 11, 56; Herman B. Bouma, 'The Tax Code and Reality: Improving the Connection' (1999) 85 *Tax Notes* 811, 813; Ryan J. Donmoyer, 'Multinationals Beg Finance to Simplify International Laws' (1999) 82 *Tax Notes* 1539; Roin, *Competition*, above n 164, 589 n.151, 590; Yin, *Reforming*, above n 19, 177; see also Avi-Yonah, *Globalization*, above n 101, 1594, 1665-66, 1670; Graetz, *Outdated Concepts*, above n 47, 328-29.

¹⁹⁹ The Australian definition of resident corporation employs the shareholder residence approach as an alternative. See *Income Tax Assessment Act 1936*, § 6(1).

²⁰⁰ For a proposal to do so, see Peroni, Fleming and Shay, *Getting Serious*, above n 20, 507-16.

²⁰¹ Graetz, *Outdated Concepts*, above n 47, 320.

²⁰² *Ibid* 323.

²⁰³ See *ibid* 331.

previously noted, failure by the United States to tax U.S. corporations on their worldwide incomes would allow U.S. resident individuals to materially avoid U.S. taxation through interposing a corporation between themselves and their foreign-source income.²⁰⁴ This would significantly undermine the ability-to-pay principle. The United States should not go down this road unless it is clearly established that there is no feasible and defensible definition of U.S. corporate residence. We do not believe that this is the case.

As explained above, a principal purpose of the U.S. tax on corporate income is to serve as an anti-deferral device that preserves the efficacy of the shareholder-level tax on the worldwide incomes of U.S. shareholders.²⁰⁵ This suggests that a definition of corporate resident is defensible if it is constructed to reach corporations with substantial numbers of U.S. resident shareholders. A definition grounded on place of incorporation (the present U.S. approach) or place of management (an approach commonly used in British Commonwealth countries²⁰⁶) might satisfy this requirement because it seems quite possible that most corporations that are incorporated or managed in the United States are substantially owned by U.S. residents. This is, unfortunately, an empirical question for which we do not have the definitive answer but which could be usefully investigated with empirical research techniques.

It is clear, however, that defining corporate residence in terms of the level of share ownership by U.S. residents would be consistent with the role of the U.S. corporate income tax as a device to protect the shareholder-level tax. Granted, if the required level of U.S. ownership were set at any point less than 100%, foreign shareholders would be overtaxed on their portion of the U.S. corporation's foreign-source income. But for the reasons stated above,²⁰⁷ this is an acceptable result in a decidedly second-best world. Moreover, the imperfection of this second-best answer makes out a case for integration, not exemption. In this second-best context, defining a U.S. resident corporation as one in which U.S. residents own some considerable percentage of the stock of the corporation, e.g., more than 50% of the vote or value of the stock, strikes us as about right.²⁰⁸

The suggestion has also been made that taxing U.S. resident corporations on their worldwide incomes is rendered indefensible by the fact that U.S. resident individuals can obtain the benefits of exemption treatment of corporate income simply by purchasing portfolio investments in the shares of corporations located in exemption

²⁰⁴ See text accompanying above n 181-94.

²⁰⁵ See text accompanying above n 181-94.

²⁰⁶ See Ault and Arnold, above n 3, 349-50.

²⁰⁷ See text accompanying above n 191-94.

²⁰⁸ One commentator has suggested that using a shareholder residence test for defining corporate residence is unworkable in the case of corporations whose shares are publicly traded, particularly where the trading occurs in more than one country. See Avi-Yonah, *Globalization*, above n 101, 1666, 1670. Nevertheless, it would seem that if the U.S. ownership threshold were set at a substantial level, say more than 50% of the vote or value of the stock, public trading would rarely create a situation in which a corporation drifted into or out of residency qualification. Cf, eg, IRC § 884(e)(4) (1986 as amended) ("qualified resident" includes more than 50% ownership by residents of a country, with a special rule for publicly traded corporations that looks to regular trading on an established securities market in that country). The problem of foreign corporations that refuse to provide information concerning the U.S. residency of their shareholders could be addressed by a presumption that each foreign corporation that solicited U.S. investors, either by registering shares for sale to U.S. persons with the Securities and Exchange Commission (SEC) or by offering shares to U.S. persons under a private placement exemption from SEC registration, is a U.S. resident under the shareholder residence test unless the corporation proves otherwise.

system countries.²⁰⁹ However, this runaway shareholder problem could be addressed by adopting a system of currently taxing U.S. resident stockholders on their shares of foreign corporate income regardless of how small their percentage of stock ownership might be.²¹⁰

In summary, we conclude that the challenges of constructing a defensible and feasible definition of corporate residence, or of dealing with U.S. residents who become portfolio investors in foreign corporations, do not rise to a level that justifies compromising the ability-to-pay principle by adopting an exemption regime with respect to the foreign-source income of U.S. corporations.

5 The Foreign Tax Credit and Ability-to-Pay

Preceding portions of this article have argued that the ability-to-pay principle requires foreign-source income of U.S. residents to be included in the U.S. tax base to the same extent as U.S.-source income. Is this argument undermined by the U.S. policy of employing a foreign tax credit to mitigate international double taxation of U.S. residents' foreign-source income?

To illustrate this issue, assume that if USCo, a U.S. resident corporation, builds its next plant in the United States, it will earn a 10% before-tax rate of return on the invested capital but that if the plant is built in Country D, the before-tax rate of return will be 15%. Clearly, the Country D investment is economically superior. Now assume that Country D taxes income earned therein at 35%, that the United States applies the same rate to its residents' worldwide incomes and that there is no United States-Country D income tax treaty. If double taxation is not ameliorated, the U.S. plant will produce a 6.5% rate of return after the 35% U.S. tax ($.10 \times [1 - .35]$) but the Country D plant will yield a only a 4.5% rate of return ($.15 \times [1 - .70]$) after the combined 70% U.S. and Country D taxes. In these circumstances, the tax system will push USCo to choose the economically inferior U.S. investment. There is broad agreement that this is an inappropriate result and that because the United States is the residence country and there is no tax convention in force that remedies the problem, the United States should act unilaterally to relieve USCo's double taxation.²¹¹

If fairness were the only consideration, we would advocate that the United States handle USCo's tax payments to Country D like any other business expense—i.e., as allowable deductions in calculating net income. Under this approach, U.S. taxpayers would pay the same rate of U.S. tax on their aggregate U.S.- and foreign-source income.

²⁰⁹ See NFTC, *International Tax Policy*, above n 72, 123. See also, Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 2.

²¹⁰ For a proposal to do so, see Peroni, Fleming and Shay, *Getting Serious*, above n 20, 507-16.

²¹¹ See Gustafson, Peroni and Pugh, above n 1, 19-21; Green, above n 148, 23-24; see also Staff of Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation* JCX-40-99 (1999) 26 <<http://www.house.gov/jct/x-40-99.htm>> (hereinafter Joint Comm., *Description*); U.S. Treas. Dep't, *Deferral*, above n 74, 25-42. But see Richard L. Doernberg, 'Electronic Commerce: Changing Income Tax Treaty Principles a Bit?' (2000) 21 *Tax Notes International* 2417, 2423 (suggesting that international double taxation is not objectionable where the sum of the two taxing countries' marginal tax rates does not exceed 10%).

The need for remedial action by the United States as the residence country is so well-settled, and so powerfully driven by the capacity of source countries to effectively claim priority for their income taxes vis-a-vis the income taxes of residence countries, that we accept it as given that the United States must act unilaterally (in the absence of an applicable income tax treaty) to mitigate international double taxation when the United States is in the residence country role.

Although allowing only a deduction for foreign taxes would satisfy the ability-to-pay criterion, it would, however, leave USCo with a substantial tax disincentive to pursue the superior Country D investment. To illustrate this fact, assume that in the preceding example, USCo is deciding between investing \$1,000 in a U.S. plant (with a 10% before-tax rate of return) and \$1,000 in a Country D facility (with a 15% before-tax rate of return) and that the United States treats Country D tax payments as a deductible business expense. The \$1,000 Country D investment would produce \$150 of before-tax net income for Country D tax purposes ($\$1,000 \times .15$) and a \$52.50 tax ($\$150 \times .35$) would be paid to Country D. For U.S. tax purposes, however, before-tax net income in this case would be $\$150 - \$52.50 = \$97.50$ and \$34.13 would be payable to the U.S. Treasury ($\$97.50 \times .35$). Thus, after payment of both taxes, USCo would have \$63.37 of its \$150 left. By contrast, investment of the \$1,000 in a U.S. plant would produce \$100 of before-tax net income ($\$1,000 \times .10$) and \$65 after the 35% U.S. tax ($\$100 \times [1 - .35]$). All other factors being neutral, USCo would invest in the economically inferior U.S. plant because of its higher after-tax return. In other words, the U. S. decision to treat the Country D tax payment as a business expense deduction in this case would not overcome the double-tax barrier to USCo's making the superior Country D investment and would not remedy the double-tax problem in a wide range of other cases.

Thus, the United States has been faced with a choice between (1) pursuing a tax system that is totally faithful to fairness concerns (i.e., that treats foreign tax payments as income tax deductions) but that leaves international double-taxation substantially in place as a barrier to its residents' foreign business and investment activities, or (2) finding a way to ameliorate the double-tax barrier while preserving the ability-to-pay tax base to the greatest extent possible.

The first alternative has been judged unacceptable and it is difficult to quarrel with this outcome. The issue then is which of the generally accepted methods to ameliorate double taxation is superior from a fairness perspective. For reasons given in previous parts of this article, we submit that adopting a foreign tax credit system while prohibiting deferral of any residual U.S. tax remaining after allowance of the foreign tax credit is the preferred way to achieve fairness and efficiency objectives.²¹²

6 *Creeping Towards Consumption Taxation*

Consumption tax devotees might object to this conclusion. This is because corporate income is not taxed under a theoretically pure cash-flow consumption tax²¹³ and although corporations appear to be taxpayers under a value added tax or a retail

²¹² "Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign-source income." Joint Comm., *Description*, above n 211, 26.

We use the term "residual tax" in its conventional sense—i.e., the residence country tax liability remaining after allowance of a credit for source country tax that was levied at a lower rate than the residence country tax.

Deferral of residual tax refers to the feature of many residence country tax systems that generally allows payment of residual tax on income earned through a foreign corporation to be postponed until residents receive dividends or sell their stock. Deferral reduces the present value of residual tax and allows residents who defer for lengthy periods to achieve the approximate result of an exemption system.

For a discussion of why a deduction is sufficient to achieve fairness objectives, see Kaufman, above n 143, 177-78.

²¹³ See U.S. Treas. Dep't, *Blueprints*, above n 108, 133; U.S. Treas. Dep't, *Tax Reform*, above n 147, 208.

sales tax, those levies are actually borne by consumers with corporations serving as mere collection agents for the government.²¹⁴ Thus, consumption tax advocates might see the near-zero U.S. corporate tax that can be achieved through deferral of U.S. tax on controlled foreign corporation income as a welcome incremental step towards a comprehensive consumption tax regime.²¹⁵

We submit, however, that granting consumption tax treatment to income earned through a controlled foreign corporation (as well as to other items such as IRA contributions), while generally maintaining an income tax regime with respect to domestic income-producing activities, creates unacceptable distortions in taxpayer investment decisions. If a consumption tax regime is the right approach for providing most of the federal government's revenues (we believe that it is not), then Congress should adopt a comprehensive consumption tax instead of including ad hoc, distortive consumption tax features in the income tax. In making this argument, however, we recognize that administrability concerns may require consumption tax treatment of certain items (e.g., unrealized appreciation) with the result that the federal income tax likely will continue to be a hybrid income-consumption tax regime. Nevertheless, the distortion and unfairness that result from deferral of controlled foreign corporation income persuasively argue against including the feature of deferral in the U.S. income tax regime.

7 Tax Competition and Exemption

Many countries offer low general income tax rates or specific income tax incentives, such as tax holidays for set periods, to attract investments within their borders by nonresidents. This approach to international economic development has recently become identified as "tax competition."²¹⁶

(a) Tax Competition and the Incentive to Invest Abroad

In an international context, the tax competition strategy is negated to the extent that capital exporting residence countries maintain systems of worldwide taxation without deferral. This is because such a residence country collects a current residual tax equal to the excess of its regular tax over the low taxes paid by its residents to tax

²¹⁴ See Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform* (1997) ch. 2; Staff of Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, JCS-18-95 (1995) 51-55 <<http://www.house.gov/jct/s-18-95.pdf>> .

²¹⁵ For a more detailed examination of the parallels between a consumption tax regime and deferral of U.S. tax on income earned through a controlled foreign corporation, see Peroni, Fleming and Shay, *Getting Serious*, above n 20, 466-68.

Some have argued that changes in the U. S. federal income tax over many years have effectively converted it into a consumption tax or a hybrid income-consumption tax. See, eg, Stuart Karlinsky and Hughlene Burton, 'America's Inexorable Move to a Consumption-Based Tax System, or Why Warren Buffett Is Winning the Class Tax War' (2004) 105 *Tax Notes* 699. We strongly disagree and argue that the U.S. federal income tax is primarily a tax on income with targeted tax expenditures that have consumption tax characteristics. See Fleming and Peroni, *Tax Expenditure Analysis*, above n 10, 511-17.

²¹⁶ See Avi-Yonah, *Globalization*, above n 101, 1575-76. In 1998, the OECD Council adopted a report identifying certain practices as harmful tax competition. See OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998). In this report, the OECD made a number of recommendations, including that countries enact controlled foreign corporation and passive foreign investment company regimes in order to combat harmful tax competition. See OECD, *Harmful Tax Competition: An Emerging Global Issue*; see also Gustafson, Peroni and Pugh, above n 1, 600.

competitors. Thus the investment inducing effect of low source taxes is negated by the residual tax.²¹⁷ However, the deferral of U.S. tax on foreign-source income that is permitted under the present U.S. system substantially reduces the impact of the U.S. residual tax and permits U.S. residents to capture a significant part, if not all, of the benefit from low tax rates offered by countries as investment incentives.²¹⁸ If the United States adopted an exemption system with an explicit zero tax rate on the foreign-source income of U.S. residents, the enjoyment of low foreign tax rates by U.S. residents who invest in countries offering these tax incentives would be accomplished more directly. Thus, a defense of tax competition can be seen as an integral part of building the case in favor of deferral and exemption.²¹⁹

Advocates of tax competition argue that it promotes capital formation by creating worldwide pressure for lower taxes²²⁰ and that it causes governments to be less wasteful.²²¹ They further argue that tax competition enhances worldwide economic efficiency by encouraging the nations of the world to arrange themselves into a menu of countries with varying mixes of tax burdens and government service levels from which investors can choose the combinations that most appeal to them.²²²

By contrast, the critics of tax competition argue that it forces countries to shift their taxes from wealthy owners of mobile capital to relatively immobile and less wealthy workers, and to reduce taxes and to cut back services and benefits so that the unfortunate members of society receive less protection from a meaner globalized world.²²³ The popular description of this phenomenon is the "race to the bottom."²²⁴

Both the claimed benefits and asserted harms of tax competition must be regarded as significantly speculative at present.²²⁵ What is clear, however, is that the combination of tax competition and the current U.S. system of worldwide taxation with deferral distorts the decision making of U.S. residents by encouraging them to locate their income earning activities in low-tax countries instead of in the United

²¹⁷ See Gustafson, Peroni and Pugh, above n 1, 368-69; Alan R. Rado, *United States Taxation of Foreign Investment: The New Approach* (1963) 51; Avi-Yonah, Globalization, above n 101, 1642; William W. Park, 'Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits' (1978) 78 *Columbia Law Review* 1609, 1637; Roin, Competition, above n 164, 547. In the United States, the term "tax competition" previously was associated principally with competition among sub-national political jurisdictions. Within the United States, constitutional restrictions on burdens on interstate commerce limit the ability of States to combat tax reduction incentives of other States other than by matching the tax reduction. As discussed in the text, in an international context it is permissible for a residence country to counteract source country income tax incentives by imposing tax on the same income.

²¹⁸ See Peroni, Fleming and Shay, Getting Serious, above n 20, 464-66; Surrey, above n 164, 823.

²¹⁹ See generally Mastromarco, above n 164; Mitchell, above n 164, 814; Patti Mohr, 'Armeiy Asks O'Neill to Reverse U.S. Policy on OECD Tax Haven Strategy' (2001) 90 *Tax Notes* 1765; Center for Freedom and Prosperity, 'Center for Freedom and Prosperity Praises U.S. Administration's Policy Towards OECD's Harmful Tax Initiative' (2001) 22 *Tax Notes International* 2621, 2622.

²²⁰ See Mitchell, above n 164, 805.

²²¹ See *ibid.*

²²² See Roin, Competition, above n 164, 554-61.

²²³ See Avi-Yonah, Globalization, above n 101, 1575-79.

²²⁴ See Roin, Competition, above n 164, 549.

²²⁵ See John E. Anderson and Robert W. Wassmer, *Bidding for Business, The Efficacy of Local Development Incentives in a Metropolitan Area* (2000); Avi-Yonah, Globalization, above n 101; Mitchell, above n 164; Beverly I. Moran, 'Economic Development: Taxes, Sovereignty, and the Global Economy' in Karen B. Brown and Mary Louise Fellows (eds), *Taxing America* (1996) 197; Roin, Competition, above n 164; Vito Tanzi and Howell H. Zee, 'Tax Policy for Emerging Markets: Developing Countries' (2000) 53 *National Tax Journal* 299, 315-19; Edwin van der Bruggen, 'Momentum Builds in Asia to End Tax Holidays' (2000) 21 *Tax Notes International* 2565.

States.²²⁶ Adoption of a generally applicable exemption system would only worsen this situation. Indeed, one tax competition advocate²²⁷ has recognized this weakness in an exemption system and suggested mitigating the problem with a partial exemption system.²²⁸ We believe that this is not a workable solution, however.²²⁹

Finally, it is also clear that deferral and exemption violate the ability-to-pay norm. The use of the mantra of tax competition to bring about back-door pressure for reductions in U.S. tax rates does not provide sufficient justification for the United States to either continue deferral or explicitly exempt foreign-source income from the income tax base.

(b) Assistance to Poor Countries

If the foregoing were the sum and substance of the tax competition debate, this article's discussion of the subject would be concluded. However, tax competition advocates advance another important argument for their position. They contend that in a world where direct aid from prosperous countries to impoverished nations is small in relationship to needs, the only practical way for desperately poor countries to get essential economic development funds is to engage in tax competition that attracts investments of privately held capital from corporate and individual residents of comparatively high-tax countries.²³⁰ For the reasons explained above,²³¹ the immediate residual tax resulting from a worldwide taxation system without deferral would be deadly to the tax competition strategy of poor nations. This suggests the argument that the United States should maintain deferral as an accommodation to impecunious countries and that, even better, the United States should facilitate the tax competition efforts of poor nations by moving to an across-the-board exemption system.²³²

Of course, the sovereign status of the United States means that it is free to tax its residents without regard to the impact of the U.S. revenue regime on the development strategies of impoverished countries.²³³ Thus, to argue that the United States should assist developing countries through deferral or exemption is to argue that the United States should provide discretionary foreign aid, and that it should do so through a tax expenditure program²³⁴ instead of a direct appropriation scheme.

The wisdom of maintaining deferral, or of adopting a general exemption system, to provide assistance to foreign countries that engage in tax competition can be usefully tested by assuming that the universe of tax competitors consists of the following four nations:

Celtica - an economically developed country with per capita gross domestic product in the top third of all nations but which,

²²⁶ See text accompanying notes 68-71.

²²⁷ See Roin, Competition, above n 164, 588-89, 591-93.

²²⁸ See Fleming, Peroni and Shay, Fairness, above n 2, 334-35.

²²⁹ See *ibid.*

²³⁰ See Robert Goulder, 'Heritage Foundation Criticizes OECD War Against Tax Havens' (2000) 21 *Tax Notes International* 1628, 1630; Mitchell, above n 164, 810, 814-15; Roin, Competition, above n 164, 559, 585; Letter from Congressman Major R. Owens to Treasury Secretary Paul H. O'Neill (February 7, 2001); Letter from Congressman Charles Rangel and 25 others to Treasury Secretary Paul H. O'Neill (March 14, 2001).

²³¹ See text accompanying above n 217.

²³² See Roin, Competition, above n 164, 586; Surrey, above n 164, 823-24.

²³³ See authorities cited in above n 164.

²³⁴ See generally, Fleming and Peroni, Tax Expenditure Analysis, above n 10.

nevertheless, maintains a general corporate tax rate of 12% to attract investment from other countries.

Hostilia - a poor country that is unfriendly to the United States and its allies, that provides bases for terrorist groups and that is using its limited resources to develop weapons of mass destruction.

Incorrectia - a poor country that is ruled by a corrupt dictator and a small group of cronies. Incorrectia oppresses women and racial and religious minorities and generally circumscribes civil liberties. It has a general tax rate for resident corporations of 30% but it attracts foreign investment with a zero corporate tax rate for 5 years and a 5% rate thereafter. Incorrectia also trumpets its minimal environmental and worker safety rules and the availability of child labor as further reasons for foreign multinationals to operate on its soil. Additionally, it is on the Financial Action Task Force's list of countries that have failed to take adequate steps to prevent money-laundering.²³⁵

Freelandia - a poor democratic country with full civil liberties and equality for all residents, environmentally friendly policies and progressive worker safety and child labor rules. Freelandia applies a 5% tax rate to both foreign and domestic corporations. One of its major political parties, however, has begun to argue that Freelandia should cut back on enforcement of environmental, child labor and worker safety rules so that it can afford to offer a five-year tax holiday like Incorrectia's.

If the United States were considering a program of direct economic development foreign aid to these four countries, a plausible outcome is that no assistance would be provided to the first three and that Freelandia would receive aid only if it gave assurances that it would not significantly degrade enforcement of its environmental, child labor and worker safety regulations.²³⁶ Therefore, a tax expenditure scheme should not be substituted for the direct aid program unless the tax expenditure plan allows the kinds of nuanced distinctions between candidate countries that would be features of a direct aid program.²³⁷ Neither a general exemption system nor a broad deferral system satisfies this criterion because both approaches would confer assistance on all four of these countries indiscriminately.

²³⁵ See Cordia Scott, 'FATF Releases New Money-Laundering Blacklist' (2001) 23 *Tax Notes International* 8.

²³⁶ It is not our purpose here to engage in a debate with those who regard economic assistance to poor countries as unwise. See, eg, Steven E. Landsburg, 'The Imperialism of Compassion', *The Wall Street Journal* (New York City) July 23, 2001, A14.

Being poor means making hard choices.... Third Worlders are making pretty much the same choices that Americans and other westerners made back in the 19th century when we were poor: They're not worrying a whole lot about the quality of their environment, and they're not spending a lot of quality time with their families. Instead, they're working long, hard, dirty hours to earn enough to eat. And they're putting their children to work, just as poor people have always done.

We only wish to illustrate the point that if a decision is made to provide economic aid to poor countries, a direct economic aid program will make distinctions, hopefully rational ones, among countries that are potential aid recipients.

²³⁷ See generally Karen B. Brown, Transforming the Unilateralist into the Internationalist, in *Taxing America*, above n 225, at 214, 217-18, 230; Graetz, Outdated Concepts, above n 47, 309.

The logical response to the preceding concerns is to engage in negotiated tax sparing.²³⁸ If a foreign country offers a concessionary tax rate to foreign investors that is below the country's normal rate, the tax sparing concept would have the United States give a foreign tax credit equal to the amount of the country's generally applicable tax.²³⁹ Where the selected country employs a low general tax rate without special concessions for foreign persons, the tax sparing concept would require a U.S. foreign tax credit that combines both the foreign tax paid and at least part of the difference between the low foreign rate and the U.S. rate.²⁴⁰ This system could be established by congressional enactment of a list of approved low-tax countries or a set of criteria that defines countries eligible for tax sparing.²⁴¹ This approach, however, would inevitably prove awkward in dealing with the diverse array of developing countries and with changes in their tax systems.

A better method would be for the United States to negotiate tax sparing provisions in bilateral tax treaties with low-tax countries.²⁴² This latter method would allow

²³⁸ The Organization for Economic Co-Operation and Development (OECD) has issued a report on tax sparing, which seeks to develop among the OECD countries "a more coherent position on the granting and design of tax sparing provisions." OECD, *Tax Sparing: A Reconsideration* (1998) 3. The OECD report states: "[t]his report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so." OECD, *Tax Sparing: A Reconsideration*, at 42. The OECD report, however, did identify "a number of concerns that put into question the usefulness of the granting of tax sparing relief." including (1) the vulnerability of tax sparing to taxpayer abuse; (2) the effectiveness of tax sparing as a method for providing foreign aid and promoting economic development; and (3) "general concerns with the way in which tax sparing may encourage countries to use tax incentives." OECD, *Tax Sparing: A Reconsideration*, at 41; see also Gustafson, Peroni and Pugh, above n 1, 370.

For a sampling of the commentary on tax sparing, see Timo Viherkentta, *Tax Incentives in Developing Countries and International Taxation* (1991); William B. Barker, 'An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!' (2007) 29 *University of Pennsylvania Journal of International Law* 349; Mary Bennett, 'Reflections on Current U.S. Policy for Developing Country Tax Treaties' (1990) 2 *Tax Notes International* 698; B. Anthony Billings and Gary A. McGill, 'Tax Sparing on U.S. Multinationals' (1990) 48 *Tax Notes* 615; Karen Brown, 'Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?' (2002) 23 *University of Pennsylvania Journal of International Economic Law* 45; Richard D. Kuhn, 'United States Tax Policy with Respect to Less Developed Countries', (1963) 32 *George Washington Law Review* 261; Damian Laurey, 'Reexamining U.S. Tax Sparing Policy with Developing Countries: The Merits of Falling in Line with International Norms', (2000) 20 *Virginia Tax Review* 467; Jeffrey Owens and Torsten Fensby, 'Is There a Need to Reevaluate Tax Sparing?' (1998) 16 *Tax Notes International* 1447; Pugh, above n 74, 267, 270-71.

²³⁹ This is the usual situation in which the tax sparing issue arises. See Gustafson, Peroni and Pugh, above n 1, 368-70; Roin, Competition, above n 164, 547 n.17.

²⁴⁰ The question of whether to grant tax sparing does not usually arise in this situation because countries usually engage in tax competition through narrowly targeted tax incentives rather than by adopting a low general rate. However, one of the objections to tax sparing is that it abets the distortion that results when a foreign country creates exceptions to its generally applicable tax rate by conferring concessionary rates on a narrow class or classes of activities. See Joint Comm., *Description*, above n 211, 87. Thus, if a developing country responds to this objection by choosing to attract foreign investment through lowering its generally applicable tax rate instead of creating narrow tax concessions, its candidacy for tax sparing should be regarded as enhanced.

²⁴¹ See IRC §§ 901(j), 999 (1986 as amended).

²⁴² Of course, the United States does not presently have income tax treaties with many low-tax developing countries. Our recommendation would require a change on this point.

One of the traditional U.S. objections to tax sparing through bilateral treaties has been that tax sparing amounts to giving the affected foreign-source income a lower tax burden than domestic-source income and that this ought not to be accomplished through the treaty process. See Staff of Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS-6-91 (1991) Part Two §II.H.1. (hereinafter Joint Comm., *International Competitiveness*). The logic of this position is

appropriate distinctions to be made among nations and would assist the United States in negotiating appropriate reciprocal tax concessions for its residents.²⁴³ It also would allow a sunset feature to be included in the tax sparing article of the Freelandia treaty so that the article could be revisited periodically and changed if Freelandia "cheats" on the deal by significantly compromising its concern for children, the environment and the safety of its workers.²⁴⁴

The United States has historically resisted tax sparing.²⁴⁵ One of the principal reasons for doing so is the fear that granting tax sparing would encourage poor countries to engage in tax competition by lowering their rates and sacrificing needed revenues.²⁴⁶ In addition, the cost effectiveness of this form of foreign aid is highly questionable. The U.S. domestic experience with former section 936 of the Internal Revenue Code is instructive. Income tax incentives in the form of reduced tax rates favor the highest profit margin industries, such as pharmaceuticals and electronics. In Puerto Rico, the U.S. General Accounting Office found that before the amendments to severely restrict section 936 in 1996,²⁴⁷ the tax subsidy for an electing section 936 corporation in the pharmaceutical industry was \$70,788 per worker, which was 267% of the average wages paid to pharmaceutical workers.²⁴⁸ This experience suggests that, to be cost effective, there would have to be a close monitoring of the effects of the subsidy.

Our purpose, however, is not to provide a full analysis of tax sparing in this article. Instead, the larger point to be drawn from this discussion is that if a full consideration of the costs and benefits establishes that the United States should assist poor countries by accommodating tax competition, bilateral tax sparing agreements are a better approach for doing so than deferral or exemption. Stated differently, the tax competition strategies of impoverished countries do not establish a case for compromising the ability-to-pay principle by maintaining the current deferral system or by adopting a generally applicable exemption system for foreign-source income of U.S. residents.

not convincing, assuming that the United States decides that tax sparing is a desirable way to assist low-tax developing countries.

²⁴³ See Peggy Brewer Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (1963) 70.

²⁴⁴ See Richman, above n 243, 70. However, one of us has previously cautioned that use of tax penalty or "negative tax expenditure" provisions as a means of achieving nontax policy objectives should undergo a cost-benefit analysis. See, eg, Peroni, Back to the Future, above n 68, 1010. This author would also apply the same caution to use of tax sparing provisions as a means of achieving child protection, worker safety or environmental protection goals.

²⁴⁵ See Gustafson, Peroni and Pugh, above n 1, 369-70; Brown, above n 237, 224-25.

²⁴⁶ See Joint Comm., *Description*, above n 211, 87.

²⁴⁷ See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1601, 110 Stat. 1755, 1827. The 1996 legislation terminated the § 936 credit for new claimants and phased the credit out over a 10-year period for existing claimants.

²⁴⁸ See United States General Accounting Office, *Pharmaceutical Industry Tax Benefits of Operating in Puerto Rico*, reprinted in 138 Cong.Rec. 11376, 11377 (May 14, 1992). For critiques of the cost effectiveness of § 936 as a tax subsidy device, see Thomas R. Barker, 'Ending "Welfare As We Know It" (Corporate Welfare, That Is): International Taxation and the Troubled History of Internal Revenue Code Section 936' (1997) 21 *Suffolk Transnational Law Review* 57; Nancy H. Kaufman, 'Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?' 1984 *Wisconsin Law Review* 531; Camilla E. Watson, 'Machiavelli and the Politics of Welfare, National Health, and Old Age: A Comparative Perspective of the Policies of the United States and Canada' 1993 *Utah Law Review* 1337, 1402.

G VAT or GST Comparison

VAT or GST regimes are typically based on the destination principle—i.e., they tax imports but apply a zero rate to export sales²⁴⁹. They also provide rebates of VAT/GST paid on inputs that were incorporated into exported items.²⁵⁰ This is a form of territorial, or exemption, treatment.²⁵¹ Professor James R. Hines, Jr. has argued that because efficiency and fairness objections have not been raised with respect to this feature of the typical consumption tax regime, the efficiency and fairness arguments that we have made above with respect to territorial income taxation are without merit. He states:

The same fairness argument that favors subjecting foreign income to domestic income taxation would also favor subjecting foreign value added to domestic value added taxation, foreign sales to domestic sales taxation, and similarly extending other domestic taxes to foreign activities. Why is there not a groundswell of fairness-motivated objection to the territoriality of value added taxes...?²⁵²

Double consumption taxation is, indeed, an issue with respect to export sales. If exporting country A adopts the so-called origin principle, thereby applying its VAT/GST to export sales but not to imports, and if other countries follow the destination principle practice of applying their VATs/GSTs to imports, the result will be a double tax on A's export sales and A's exporters will be competing against local sellers whose transactions bear only a single VAT/GST. Thus, a country that organizes its VAT/GST on the basis of the origin principle effectively allows every other country in the world to erect a double tax barrier against its export sales²⁵³ and this barrier could have untoward effects for its economy.²⁵⁴ Thus, an origin principle VAT/GST, which is roughly the consumption tax analogue to worldwide taxation of income without a foreign tax credit, is unattractive for prudential reasons.²⁵⁵ That fact gives exporting countries an incentive to look for other double taxation mitigation approaches when designing their VATs/GSTs.

In theory, a possible alternative would involve an exporting country mitigating double VAT/GST taxation by crediting the importing country's consumption tax against the exporting country's consumption tax. In the real world, however, this is a

²⁴⁹ See Slemrod and Bakija, above n 141, 139, 235-37; Victor Thuronyi, *Comparative Tax Law* (2003) 318-19; Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers, *The Modern VAT* (2001) 176-77, 184.

²⁵⁰ See authorities cited in above n 249.

²⁵¹ See Ebrill, Keen, Bodin and Summers, above n 249, 179-80.

²⁵² Hines, *Reconsidering*, above n 72, 34-35.

²⁵³ This double tax barrier is permitted by WTO rules. See Staff of Joint Committee on Taxation, *Impact on Individuals and Families of Replacing the Federal Income Tax* JCS-8-97 (1997) 71-72 <<http://www.house.gov/jct/s-8-97.pdf>> (hereinafter Joint Comm., *Impact*).

²⁵⁴ The negative effects could include reduced domestic wages and reduced export sales due to sluggishness in exchange rate adjustments. See Joint Comm., *Impact*, above n 253, 96-98.

²⁵⁵ Moreover, the origin principle VAT/GST has the appearance of being a barrier to export sales because it taxes them. By contrast, the destination principle VAT/GST has the appearance of an export promotion scheme because of its zero rating of export sales coupled with its rebates for VAT/GST paid on inputs incorporated into exported items. Economists insist that these appearances are substantially illusory, see Slemrod and Bakija, above n 125, 139-40; Grubert and Newlon, above n 10, 628-30. However, the economists' argument is not easy for politicians to explain in brief sound bites and for voters to grasp and so the export-friendly appearance of the destination-principle VAT/GST probably gives it an advantage in the realm of practical politics. See Slemrod and Bakija, above n 141, 139, 237; Grubert and Newlon, above n 10, 628.

problematic solution because consumption taxes are applied on a transactional basis and it is difficult to account for a multitude of separate foreign consumption tax payments. Thus, a destination or territorial approach—i.e. applying a zero VAT/GST rate to exports—is the more feasible alternative.²⁵⁶ By contrast, income taxes are imposed on an aggregate basis that ultimately produces a single annual credit for a residence company with respect to all of its foreign profits. This practical distinction between a VAT and an income tax indicates that the international custom of operating consumption taxes on a territorial basis seems to have a utilitarian explanation that does not impeach the arguments in favor of worldwide income taxation.

IV CONCLUDING OBSERVATIONS: WEIGHING THE FACTORS

Exemption system advocates are inclined to ask why, if some other countries directly confer the advantages of an exemption system on their residents, should the United States treat its residents less favorably by holding to a worldwide system?²⁵⁷ The answer is that the United States might choose to do so because it gives higher priorities to locational neutrality and to fairness in the design of its income tax rules than is implied by the choice of an exemption system.

To be specific, the U.S. income tax is heavily grounded on the fairness notion that taxpayers should contribute to the cost of government in relationship to their comparative economic wellbeing or ability-to-pay.²⁵⁸ Territorial taxation facially conflicts with this norm to the extent that it excludes foreign-source income from the ability-to-pay calculus. This point is not the end of the matter, of course, because the goals of simplicity, economic neutrality/efficiency and economic growth must also be taken into account and may require that fairness concerns be somewhat circumscribed.

With respect to simplification, exemption system proponents argue that an exemption regime would advance the goal of reducing complexity in the tax system.²⁵⁹ After all, what could be simpler than not taxing foreign-source income at all? Adoption of an exemption regime might, indeed, simplify the U.S. system for taxing its residents' foreign-source income, but the amount of simplification to be gained by the switch from a worldwide approach is uncertain and may not be great. This is largely due to the fact that adoption of a regime that provides an explicit zero rate of tax for foreign-source income will heighten the importance of those elements of the system dealing with the distinction between U.S.-source and foreign-source net income. Thus, the sourcing rules, transfer pricing rules and expense-allocation rules will inevitably assume a greater role under an exemption regime than under the present worldwide system. We should expect that these rules would all be tightened in the exemption context, thereby becoming more complex and more productive of controversy between taxpayers and the IRS.²⁶⁰

²⁵⁶ Moreover, a destination principle VAT/GST avoids transfer pricing problems that are inherent in an origin principle VAT/GST. See Grubert and Newlon, above n 10, 620, 639.

²⁵⁷ See generally, NFTC, *International Tax Policy*, above n 72, 126-27.

²⁵⁸ See authorities cited in above n 148.

²⁵⁹ See Chorvat, above n 68, 850-53.

²⁶⁰ See generally Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 36-37, 40-41; U.S. Treas. Dep't, *Approaches*, above n 2, 60; Michael J. McIntyre, 'Thoughts on the IRS's APA Report and More Territorial Taxation' (2000) 87 *Tax Notes* 445, 446; Peter R. Merrill, 'International Tax and Competitiveness Aspects of Fundamental Tax Reform' in James M. Poterba (ed), *Borderline Case* (1997) 87, 103; Peroni, Back to the Future, above n 68, 985; David R. Tillinghast, 'International Tax Simplification' (1990) 8 *American Journal of Tax Policy* 211-12.

Moreover, to mitigate fairness and economic efficiency/neutrality concerns, some countries exclude both passive income and low-taxed foreign-source business income from their exemption systems (indeed, most countries exclude passive income from their exemption systems) and employ a worldwide system (with a foreign tax credit) for this excluded income.²⁶¹ If the United States went down this road and preserved its worldwide system (with its complex foreign tax credit) for passive and low-taxed foreign-source income, the simplification gains from an exemption system could be slim indeed.²⁶²

In addition, some exemption countries have determined that although a resident's foreign-source income should be excluded from the tax base, it should, nevertheless, be taken into account for purposes of determining the progressive tax rate that applies to the resident's domestic-source income. This principle is generally referred to as exemption-with-progression.²⁶³ If the United States were to adopt this approach, the issue of whether or not to recognize unrepatriated controlled foreign corporation income when implementing exemption-with-progression would be critically important and might well result in the preservation of complex antideferral regimes for this purpose. If so, the simplification gains from converting to an exemption system would be significantly reduced.

An exemption system is also a highly distortionary departure from the goal of economic neutrality. At its worst, an exemption system can cause an investment in a low-tax foreign country to be preferred to a U.S. investment even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.²⁶⁴ It is difficult to see how the economic well-being of the United States is furthered by distorting taxpayer decisions in this manner.

With respect to economic growth, exemption advocates contend that exemption systems create greater worldwide economic well-being than do worldwide taxation systems.²⁶⁵ The empirical and theoretical support for this proposition is, however, so mixed and debatable that the claimed economic growth virtues of the exemption approach must be regarded as speculative at best.²⁶⁶

²⁶¹ See Ault and Arnold, above n 3, 372-75, 378-79; Chorvat, above n 68, 855-59; Graetz, Outdated Concepts, above n 47, 324, 329; See also H. David Rosenbloom, 'From the Bottom Up: Taxing the Income of Foreign Controlled Corporations' (2001) 26 *Brooklyn Journal of International Law* 1525, 1549-50; Tillinghast, above n 260, 209-10.

²⁶² See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 38-41; Charles I. Kingson, 'The Foreign Tax Credit and Its Critics' (1991) *American Journal of Tax Policy* 1, 52-55; Peroni, Back to the Future, above n 68, 986. Although Australia generally employs an exemption regime for foreign-source income, it taxes certain foreign-source income under a worldwide system that features an anti-deferral regime described as "very complex." Robin Woellner, Steven Barkoczy, Shirley Murphy and Chris Evans, *Australian Taxation Law* (17th ed. 2006) 1,465.

²⁶³ See Ault and Arnold, above n 3, 372-73. The United States actually employs the exemption-with-progression principle in its limited exemption for foreign-source personal service income. See IRC § 911(f)(1986 as amended).

²⁶⁴ See text accompanying notes 68-71 *supra*; Avi-Yonah, Globalization, above n 101, 1604 n. 132; See also Jane G. Gravelle, 'Foreign Tax Provisions of the American Jobs Act of 1996' (1996) 72 *Tax Notes* 1165,1166; Mitchell, above n 164, 804; Peroni, Back to the Future, above n 68, 983; Peroni, End It, above n 68, 1613-14.

²⁶⁵ See, eg, Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (1992) 57-59.

²⁶⁶ See, eg, Staff of Joint Committee on Taxation, *Overview of Present-Law Rules and Economic Issues in International Taxation*, JCX-13-99 (1999) §IV.D <<http://www.house.gov/jct/x-13-99.htm>>; U.S. Treas. Dep't, *Deferral*, above n 47, 25-54; Altshuler, above n 80, 1585; James R. Hines, Jr., 'The Case Against Deferral: A Deferential Reconsideration' (1999) 52 *National Tax Journal* 385, 401-02; Rousslang, above n 68, 595-97.

Likewise, the claims that adoption of an exemption system by the United States is necessary to keep U.S. businesses on a competitive footing in foreign markets are rendered dubious, at best, by the extensive overseas success of those businesses.²⁶⁷ Advocates of the competitiveness view have failed to provide convincing empirical evidence for their claims that worldwide taxation undermines the ability of U.S. individuals and corporations to compete in the global marketplace.²⁶⁸

In addition to the preceding points, Part III.E.7 has discussed ways to overcome objections to worldwide taxation that are based on a desire to accommodate the tax competition strategies of poor countries.²⁶⁹

Thus, it is quite rational for the United States to conclude that when the significance of the ability-to-pay fairness principle is weighed against an exemption system's distortionary effects, uncertain simplification benefits²⁷⁰ and speculative economic growth consequences, and against the generally strong competitive performance of U.S. businesses abroad, worldwide taxation is the preferred option. This holds true regardless of the fact that other countries, with other ideas regarding the relative importance of fairness and efficiency, countenance generous deferral of foreign-source income or employ exemption systems.²⁷¹

Although the application of the ability-to-pay fairness principle to international income taxation is complicated by the presence of foreign taxpayers, by income earned through C corporations and by the claims of other governments to tax cross-border income, it is nonetheless possible, and indeed important, to analyze international tax policy in terms of fairness in addition to efficiency. As the foregoing discussion demonstrates, we believe that both fairness and efficiency considerations support the conclusion that a properly designed worldwide income tax regime is superior to either the current U.S. hybrid worldwide system²⁷² or an exemption system.

²⁶⁷ See U.S. Treas. Dep't, *Deferral*, above n 47, 56.

²⁶⁸ See U.S. Treas. Dep't, *Deferral*, above n 47, 56-57, 61.

²⁶⁹ See text accompanying above n 238-44.

²⁷⁰ See text accompanying above n 259-63.

²⁷¹ See Reuven S. Avi-Yonah, 'Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy' (2000) 21 *Tax Notes International* 2841, 2843 (arguing that an exemption system, as typically constructed, is a prohibited export subsidy under the General Agreement on Tariffs and Trade). For a more cautious view on this point, see Richard Westin and Stephen Vasek, 'The Extraterritorial Income Exclusion: Where Do Matters Stand Following the WTO Panel Report?' (2001) 23 *Tax Notes International* 337, 341-44.

²⁷² See Summers, above n 83, 39 ("[W]hen given the choice between the continuation of the status quo—which seems to me to permit very large amounts of abuse in which income is caused to be located in jurisdictions that do not seek to maintain serious tax systems and to remain there for very long periods of time—and the end of deferral, it is not clear to me that the status quo is to be preferred.").

DEVIL'S IN THE DETAIL: NON-COMMERCIAL BUSINESS LOSSES

JULIE CASSIDY*

I INTRODUCTION

When the theme for the 2008 Australasian Tax Teachers' Conference was announced (The Devil's in the Detail), the author immediately thought of the non-commercial losses provisions. These provisions are contained in Division 35 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') and restrict individuals from offsetting losses from non-commercial activities against other income. Division 35 was introduced following the Review of Business Taxation Report, *A Tax System Redesigned* ('Ralph Report').¹ The *Ralph Report* stated that the primary rationale for this reform was to improve the integrity of the taxation system by restricting loss deductions for hobby style taxpayers.² The Report asserted:

Many of these activities are no more than hobbies and/or lifestyle choices but even those that have business like characteristics (according to existing law) are often unlikely to ever make a profit and do not have a significant commercial purpose or character. They continue in a net loss position year after year, offsetting so-called business losses against other income, notably salary and wages. On average they make little or no contribution to the revenue-raising task but gain a significant tax advantage.³

The *Ralph Report* stressed that the consequent leakage of revenue that stemmed from individuals being able to offset losses from such unprofitable non-commercial business activities against other sources of income undermined the integrity of the tax system.⁴

Following on from the *Ralph Report* recommendations, Division 35 introduces a framework for determining whether losses from a business activity can be offset against other sources of income. Echoing the *Ralph Report*, s 35-5(1) provides that the object of Division 35 'is to improve the integrity of the taxation system by preventing losses from non-commercial activities that are carried on as businesses by individuals (alone or in partnership) being offset against other assessable income.' The concept underlying Division 35 is, therefore, at first glance very simple – preventing losses from non-commercial activities being offset against other sources of income. The devil, however, is in the detail. Division 35 is highly complex. These complexities permeate every aspect of the legislation, in particular:

- the operation of the loss deferral rule;
- the four threshold tests that *prima facie* determine the applicability of the loss deferral rule;
- the need to identify and separate a particular business activity;

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¹ *A Tax System Redesigned, More Certain, Equitable and Durable, Report* (1999) Australian Government Publishing Service, Canberra ('Ralph Report').

² *Ralph Report* *ibid* 295-296.

³ *Ralph Report* *ibid* 296. See also Explanatory Memorandum, *A New Business Tax System (Integrity and Other Measures) Bill 1999* [1.7]-[1.9]; *Taxation Ruling TR 2001/14* [8] and [38].

⁴ *Ralph Report* *ibid*. See also Explanatory Memorandum *ibid*; *Taxation Ruling TR 2001/14* *ibid*.

- the grouping principles;
- its application to partnerships; and
- the exercise of the Commissioner's discretion where one of the four threshold tests are not met.

This complexity is reflected in the number and size of the taxation rulings and interpretative decisions that attempt to deal with these principles. Ultimately it is concluded that a simple concept has been masticated by detail.

At other times the devil's in the lack of detail. A number of the above tests/exceptions are based on the application of undefined terms. Moreover, despite the *Ralph Report* highlighting the problems with the existing law pertaining to the definition of a business,⁵ the legislation also fails to define a 'business' or a 'business activity.' This again has led to numerous and voluminous rulings and interpretative decisions and the current trickle of cases will undoubtedly increase with time.

Effectively, Division 35 adds another layer of complexity to the existing jurisprudence pertaining to the notion of a 'business' which the *Ralph Report* recognised is a highly uncertain and resource intensive part of taxation law.⁶ It is ultimately contended that it would have been preferable for the legislature to have introduced a statutory definition of income that focuses on the common indicia of these hobby style activities identified in the *Ralph Report*; namely they are 'unlikely to ever make a profit and do not have a significant commercial purpose or character.'⁷ A statutory definition of business that requires (i) a reasonable prospect of making a profit and (ii) a profit making intent would have addressed the policy concerns expressed in the *Ralph Report* and simplified the complexity of the notion of 'business'.

II LOSS DEFERRAL RULE

Division 35 introduces a loss deferral rule, effected through s 35-10(2), that is operative from the 2000-2001 income year.⁸ Basically, the s 35-10(2) loss deferral rule provides:

an individual⁹ taxpayer¹⁰;

- who is carrying on a business;¹¹
- is prevented from offsetting losses;
- from a particular¹² business activity;¹³
- against the taxpayer's assessable income from other sources for that income year.

At first glance the operation of the loss deferral appears straightforward. Any loss

⁵ *ibid.*

⁶ *ibid.*

⁷ *ibid.*

⁸ Explanatory Memorandum *ibid* [1.3]. See also *Taxation Ruling TR 2001/14* *ibid* [4] and [6].

⁹ An 'individual' means a natural person. See *Taxation Ruling TR 2001/14* *ibid* [33].

¹⁰ Division 35 applies to 'individual taxpayers', whether acting alone or in partnership: s 35-10(1). See the discussion below as to the application of Division 35 to partnerships.

¹¹ Division 35 is not intended to apply to activities that do not constitute a business, for example, the receipt of income from passive investments: s 35-5(2). As discussed below, the notion of a business is not, however, defined in the legislation.

¹² As discussed below, the legislation is not always confined to one single business activity. At times business activities may be grouped: s 35-10(3).

¹³ As discussed below, the term 'business activity' is not defined in *ITAA 1997* otherwise that in its unhelpful definition of 'business' in s 995-1 *ITAA 1997*.

from the non-commercial business activity is treated as if it was not incurred by the individual in that income year, but may be carried forward as a loss: s 35-10(2). Thus losses from a business activity that have been deferred under s 35-10(2) are *prima facie* quarantined and can only be offset against any profits of the relevant business activity in a future income year: s 35-10(2)(b).¹⁴

The carry forward loss may in turn be offset against other income of the individual carrying on the relevant business activity in an income year in which the business activity meets at least one of the four threshold tests, discussed below: s 35-10(1)(a). Alternatively, they may be offset where the Commissioner exercises his/her discretion, discussed below, or the primary production or the professional arts business exceptions apply.

However, this *prima facie* simple loss deferral rule becomes more complex. What if the income earned from the business activity that now, for example, meets one of the four threshold tests is not sufficient to absorb the carry forward loss? Once one of triggers for allowing the loss offset has been met, any deferred loss from an earlier income year will not again be deferred under Division 35. Accordingly, all losses, including the deferred losses, attributable to an individual's business activity will be able to be offset against any assessable income of that individual. In effect, the deferred losses are no longer quarantined. Where an individual's other income is insufficient to absorb all of the losses relating to the business activity, any remaining Division 35 losses will become normal carry forward tax losses. These losses will be treated in the same way as any other carry forward loss under Division 36.¹⁵ Thus, in effect, once the threshold tests or exceptions apply, the deferred losses are no longer quarantined to the particular business activity.¹⁶

What if the business activity does not meet one of the criteria for loss offsetting, but nevertheless makes a profit in a subsequent year of income? In an income year that a business activity has a profit but does not pass, for example, one of the four threshold tests, losses deferred from prior years may be offset to the extent of this profit. Thus the deferred loss is reduced to the extent of that profit. The balance then becomes the Division 35 loss for that income year and is in turn deferred under s 35-10(2).

The loss deferral rule is also modified for an income year if the taxpayer derived exempt income: s 35-15(1). In that case, a loss that would otherwise be carried forward to a future income year under s 35-10(2)(b) is first reduced by the amount of any net exempt income of the individual taxpayer that is not applied for that income year pursuant to ss 36-10 and 36-15. This reduction is made before the individual taxpayer applies the s 35-10(2)(b) amount against assessable income from the business activity: s 35-15(2).¹⁷

The loss deferral rule is further complicated where there is a cessation of a business activity. First, as noted above, the loss deferral rule applies if the allowable deductions of the non-commercial business activity exceed the assessable income of that business activity for that income year. While the deductible amounts attributed to the business activity include all those amounts that are deductible under *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936') and *ITAA 1997*, not just s 8-1 *ITAA 1997*,¹⁸ *Taxation Ruling TR 2001/14* [57] states that the provisions do not apply to amounts that are incurred after a business activity has ceased. This comment in the

¹⁴ Explanatory Memorandum, above n 3 [1.25]-[1.26].

¹⁵ See also Explanatory Memorandum *ibid* [1.27]-[1.28].

¹⁶ See also Explanatory Memorandum *ibid* [1.22].

¹⁷ See further *Taxation Ruling TR 2001/14* above n 3 [31], [114]-[115], [171] and [172].

¹⁸ See also *Taxation Ruling TR 2001/14* *ibid* [12].

ruling relates to those long tail liabilities that continue to be deductible under s 8-1 *ITAA 1997* even though they have ‘crystallised’ and become incurred after the cessation of a business within the reasoning in *Placer Pacific Management Pty Ltd v FCT*.¹⁹

Second, the loss deferral rule operates differently where the non-commercial business activity ceases. As noted above, usually, under the loss deferral rule the loss is attributable to the next income year. However, if the business activity ceases, while the loss is carried forward, it only becomes deductible in the income year if, and when, the business activity is next conducted.²⁰ If the business activity is not recommenced, the cessation of the business means that any unused deferred losses are effectively forfeited.²¹ The loss deferral rule operates in a similar manner if a business activity is incorporated. If the taxpayer incorporates his/her business, the losses are again forfeited, as the new company cannot use any unused deferred losses. Similarly, a loss that would otherwise have been carried forward under the loss deferral rule cannot be deducted in either the current or a later income year where the taxpayer becomes bankrupt: s 36-20.²²

Thus the pivotal loss deferral rule underlying Division 35 is not as simple as it appears at first glance. The devil’s in the detail.

III THRESHOLD TESTS

As noted above, the *Ralph Report* was concerned with the revenue leakage stemming from activities that are ‘no more than hobbies and/or lifestyle choices.’²³ Echoing the *Ralph Report’s* recommendations,²⁴ the legislative response underlying Division 35’s framework for deciding what activities would be subject to the loss deferral rule was the introduction of four alternative tests:

- assessable income test;
- profits test;
- real property test; and
- other assets test.

While such tests clearly focus on the profitability and size of the business activity, indicative of the hobby v business dichotomy,²⁵ they have been subject to considerable criticism.²⁶ They favour large-scale activities that may nevertheless

¹⁹ (1995) 95 ATC 4459.

²⁰ See also Explanatory Memorandum above n 3 [1.21].

²¹ See also *Taxation Ruling 2001/14* above n 3 [54] and [131]-[132].

²² See also *ibid* [32], [116]-[117] and [173].

²³ *Ralph Report* above n 1, 296. See also Explanatory Memorandum, above n 3 [1.7]-[1.9]; *Taxation Ruling TR 2001/14* *ibid* [8] and [38].

²⁴ *Ralph Report* *ibid* 294-300.

²⁵ *Evans v FCT* (1989) 89 ATC 4540, 4554-4555; *Ferguson v FCT* (1979) 79 ATC 4261, 4264-4265; *FCT v Radnor Pty Ltd* (1991) 91 ATC 4689, 4700-4703; *Case X31* (1990) 90 ATC 296, 298; *Daff v FCT* (1998) 98 ATC 2129, 2133-2135; *Hadlow v FCT* (2002) 2002 ATC 2294; *Stone v FCT* (2003) 2003 ATC 4584; (2005) 2005 ATC 4234; *Puzey v FCT* (2003) 2003 ATC 4782.

²⁶ Robert Douglas, ‘Farmers Nil, Commissioner Nil. Thanks, Ralph Great Result’ (2001) 35 *Taxation in Australia* 387; Gordon Cooper, ‘Tax Reform: Non Commercial Losses’ (2000) 35 *Taxation in Australia* 160; Lisa Samarkovski and Brett Freudenberg, ‘TLIP: Lip Service or in Service? A Review of the Non-Commercial Loss and STS Measures Against the TLIP principles’ (2006) 21 *Australian Tax Forum* 387; Linda Greenleaf, ‘The Non-commercial loss Provisions: A Lesson in Collateral Damage?’ (2006) 21 *Australian Tax Forum* 669; Paul Kenny, ‘The Non Commercial Loss Restrictions: A Very Blunt Instrument for Micro Business’ (2006) 21 *Australian Tax Forum* 573; Taxation Institute of Australia, Submission to The Board of Taxation’s post-implementation review 29 March 2004

constitute lifestyle choices and discriminate against small legitimate business.²⁷ The tests are easily manipulated by especially the wealthy who can, for example, ensure that their hobby farm meets the real property or other assets tests.²⁸ The assessable income and profits tests can also be manipulated through deferring or accelerating income or expenditure, including trading stock.²⁹ More importantly in the context of this paper, while at first glance these tests seem decisively simple, they have proven to be otherwise. While this is particularly so when applied to partnerships, as discussed later in the paper, even the basic operation of the tests is uncertain and complicated. Once again the devil's in the detail.

A Assessable Income Test

The loss deferral rule does not apply to a business activity if in the subject income year the assessable income³⁰ from the business activity is at least \$20,000: s 35-30(a). Even the notion of what is the taxpayer's 'assessable income' is complicated under Division 35. This is indicative from the number of relevant interpretative decisions. These provide that the assessable income includes any trading stock brought to account under s 70-35(2): *ATO Interpretative Decision ID 2003/279*. Similarly, balancing adjustments under s 40-285(1) are included in the assessable income: *ATO Interpretative Decision ID 2003/288*. Interest from a business account is also included: *ATO Interpretative Decision ID 2003/332*. Funds repaid from a farm management deposit have been considered assessable income for this purpose: *ATO Interpretative Decision ID 2004/112*. A Landcare grant has also been considered assessable income: *ATO Interpretative Decision ID 2004/262*.

The application of the assessable income test is complicated where the taxpayer started, or stopped, carrying on the business activity during the subject income year. Under s 35-30(b) the test is satisfied where a reasonable estimate of the assessable income had the taxpayer carried on the activity throughout the year is at least \$20,000. Requiring an 'estimation' is of course fraught with uncertainty. How is this estimation to be made? The legislation is silent on the matter. An estimation on a *pro rata* basis would appear at first glance to be the logical approach where, as here, the business activity is conducted for only part of the year. However, the Explanatory Memorandum suggests that an estimate, rather than a pro-rating, is appropriate where seasonal variations need to be taken into account in determining the assessable income for the income year.³¹

Moreover, the legislation does not identify relevant factors in making such an estimation. This has in turn required supplementary guidance through a public ruling. *Taxation Ruling TR 2001/14* [62] states that in making a reasonable estimate, relevant factors include:

www.taxboard.gov.au/losses.submissions.asp; Taxpayers Australia, Tasmanian Divisional Council, Submission to The Board of Taxation's post-implementation review 2004, www.taxboard.gov.au/losses.submissions.asp; Rural Industries Research and Development Corporation, *Economic Effects of Income Tax Law on Investments in Australian Agriculture, With Particular Reference to New and Emerging Industries*, January 2006, <http://www.rirdc.gov.au/fullreports>.

²⁷ See also Douglas, *ibid* 390; Kenny *ibid*.

²⁸ See also Kenny *ibid*.

²⁹ See also Cooper, *above n* 26,163.

³⁰ Note under the first test it is the assessable income, rather than taxable income, that is the focus.

³¹ Explanatory Memorandum, *above n* 3, [1.31]. See *Peterson v FCT* (1960) 106 CLR 395 as an example of a seasonal partnership.

- the cyclical nature of the particular business activity that may result in variations in the pattern of receipts;
- any orders received and/or forward contracts entered into;
- the amount that could have been derived for a full income year based on a *pro rata* calculation of the assessable income already derived for the part of the year. The amount derived for the part of the year must be typical of the income derived in a full year;
- the type of business activity undertaken, considering the nature and type of income receipts of similar activities typical of the industry; and
- current size and investment in the activity.

Despite the undoubted uncertainty underlying any consequent estimation of income, *ATO Interpretative Decision ID 2003/630* states that this estimation is irrevocable.

B Profits Test

The loss deferral rule does not apply to a business activity for an income year, if, for each of at least three of the past five income years, (including the current year in which the loss has arisen), that business activity has produced taxable income: s 35-35(1). Once again, while seemingly simple, there are a number of complications incorporated into this threshold test. First, how does the test work when the business activity has been operating for less than five years? *Taxation Ruling TR 2001/14* [62] provides that it is not necessary that the business activity be carried on for five years. It suffices if, for example, a profit is made in three out of four years.³²

Second, to complicate matters more it has been suggested in *ATO Interpretative Decision ID 2003/407* that it is not necessary that the taxpayer conducted the business activity during the years in which the qualifying profits were made. This interpretative decision suggests that where there is continuity in the business activity, the profits made by the prior owner may be taken into account for this purpose. In *ATO Interpretative Decision ID 2003/407* the taxpayer purchased a primary production business from a family trust. Despite the change in ownership, that the family trust had made a profit in the four previous income years enabled s 35-35(1) to be satisfied.

Third, as to the reference to 'taxable income', s 35-35(1) provides that this is the amount where the sum of the deductions attributable to the activity for the year is less than the amount of assessable income from the activity in that year. However, in order to ensure that only those amounts that actually arise in a particular year are taken into account, the rule excludes any deferred losses that are deemed to be attributable to the activity for a particular income year by s 35-10(2)(b).³³

C Real Property Test

Under the third threshold test, the loss deferral rule does not apply to a business activity for an income year if the total value of real property used in carrying on the business activity in that year is at least \$500,000: s 35-40(1). Once again this sounds decisively simple. However, there a number of complications incorporated into the legislation. First, the legislation allows the taxpayer to choose whether to use the value of the real property itself or the value of the interest in the real property.³⁴ Thus a lessee, for example, can choose to use the value of the interest or the value of the underlying property.

³² See further *Taxation Ruling TR 2001/14*, above n 3 [93] and [137].

³³ Explanatory Memorandum, above n 3, [1.34].

³⁴ *Taxation Ruling TR 2001/14*, above n 3 [53].

Second, how is the value of the real property to be determined? The legislation allows the use of the market value or the reduced cost base.³⁵ The market value of the real property or interest may be used where the market value exceeds the reduced cost base: s 35-40(2).

Third, when is the value of real property determined? Generally the reduced cost base or market value is calculated as at the end of the income year: s 35-40(3)(a). However, once again there is a different rule in the case of a cessation of a business. Where the individual taxpayer ceased carrying on the business activity during the year the valuation date is:

- when the individual stopped the business activity: s 35-40(3)(b)(i); or
- if the individual disposed of the asset before this point but in the course of ceasing the business activity, at the time the individual disposed of the asset: s 35-40(3)(b)(ii).

Fourth, certain assets are excluded from the real property test. Specifically, a dwelling³⁶ and any adjacent land used in association with the dwelling, that is used mainly for private purposes (s 35-40(4)(a)) and fixtures owned by the taxpayer as a tenant (s 35-40(4)(b)) are excluded. These exclusions are in turn the subject of a number of rulings and interpretative decisions.³⁷

The reference to fixtures in s 35-40(4)(b) highlights a fifth complication, namely the potential overlap of the real property test and the other assets test. An asset that is fixed to land takes on the quality of the real property and thus potentially could be used under either or both tests. This in turn has required the introduction of reconciliation rules. *Taxation Ruling TR 2001/14* [26] and [27] recognises that the value of some leased assets and depreciating assets can be taken into account under either the real property test or the other assets test, but states that they cannot be used for both. In regard to leased property the ruling states that the 'general scheme is that an individual with an interest in real property comprised of fixtures owned by them as a tenant, takes the fixtures into account under the other assets test, and not under the Real property test (paragraph 35-40(4)(b)).'³⁸ In regard to depreciating assets, the ruling states 'the general scheme in this case is that where such an asset is part of the real property taken into account for the purposes of the Real property test, then it is not also counted for the Other assets test (paragraph 35-45(4)(a)).'³⁹

Returning to the general operation of the real property test, a sixth complication arises in cases that require apportioning. Section 35-50 provides that if the real property is used during the income year only partly in carrying on the business activity, only that part of the reduced cost base, market value or other value that is attributable to the use of the asset in carrying on the business activity is to be taken into account.

Finally, the real property must be used on a continuing basis in carrying on the business activity: s 35-40(1). 'Continuing' is not, however, defined in Division 35. Again this has required subsequent clarification through a public ruling. *Taxation Ruling TR 2001/14* [65] provides the term 'continuing' takes on its ordinary meaning. However, as the ruling is primarily concerned with the other assets test, discussed below, it really provides no useful guidance.

³⁵ 'Reduced cost base' has the same meaning as for capital gains tax under Subdiv 110-B of Chap 3 *ITAA 1997*: s 995-1 *ITAA 1997*. See also *Taxation Ruling TR 2001/14* *ibid* [18].

³⁶ 'Dwelling' has the same meaning as for the capital gains tax under s 118-115: s 995-1 *ITAA 1997*.

³⁷ See, for example, *Taxation Ruling TR 2001/14*, above n 3; *ATO Interpretative Decision ID 2004/510*; *ATO Interpretative Decision ID 2004/644*.

³⁸ *Taxation Ruling TR 2001/14* *ibid* [26].

³⁹ *Ibid* [27].

D Other Assets Test

The final threshold test, the other assets test, provides that the loss deferral rule does not apply to a business activity for an income year if the total value of assets (excluding real property assets)⁴⁰ used in the business activity in that year, is at least \$100,000: s 35-45(1). Again this sounds straightforward. However, the application of the threshold test requires a valuation methodology that is applicable to a variety of possible assets. In turn, the table in s 35-45(2) sets out a number of rules that are required to accommodate the various assets that might be included in the other assets test and in turn how to determine their value. Some of the valuation rules appear to be reasonably obvious. For depreciation assets, the written down value of the asset under Division 40 *ITAA 1997* is included. However, as Kenny notes, as s 35-45(2) refers to the written down value under s 40-40 *ITAA 1997*, depreciating assets under other parts of the Act, such as Division 328, are excluded.⁴¹ For trading stock, the value is its value under s 70-45(1) *ITAA 1997*. For trademarks, patents, copyrights and similar rights, the value is their reduced cost base. This matter becomes more complicated in the case of leased items. Where a taxpayer leases an asset from another entity, the value of the asset is the sum of the amounts of the future lease payments for the asset to which the taxpayer is irrevocably committed, less an appropriate amount to reflect any interest component for those lease payments. Thus the value of the underlying leased asset is not used for the purpose of s 35-45.⁴²

The other assets test also shares the same complications as the real property test, detailed above. Thus under s 34-45(3), the other assets test is subject to the same timing rule as the real property rule and is also subject to the above discussed complications when a business ceases. Similarly, apportionment may be required under s 35-50 where the asset is only partially used in the business activity.

Again, the asset must also be used on a continuing basis in the carrying on of the business activity: s 35-45(1). As noted above, 'continuing' is not defined in Division 35. *Taxation Ruling TR 2001/14* [66] states if an asset is 'used on a short-term basis for a specific task or a one-off activity' there will be no continuous use. Similarly, intermittent hiring of property is said not to meet the required degree of usage. *Taxation Ruling TR 2001/14* [65] quotes *FCT v Stewart*⁴³ to the effect that to be used on a continuing basis there must be more than 'transient or insubstantial use.' It is stated in *Taxation Ruling TR 2001/14* [66] that this does not mean that an item of machinery used in an ongoing business, but which is only used during certain periods is not used on a continuing basis. The example given is a harvester that is used only during harvest time. Clearly this legislative prerequisite is going to require a case-by-case examination of a taxpayer's circumstances to determine if usage is sufficiently continuous.

IV IDENTIFYING SEPARATE BUSINESS ACTIVITIES

As noted above, generally Division 35 is concerned with the profits and losses etc of each particular business activity.⁴⁴ This in turn requires separating within an overall enterprise any distinct business activities. This is clearly a difficult process that

⁴⁰ Cars, motor cycles and similar vehicles are also excluded under s 35-45(4).

⁴¹ Kenny, above n 26.

⁴² *Taxation Ruling TR 2001/14*, above n 3 [64].

⁴³ (1984) 84 ATC 4146.

⁴⁴ See also Explanatory Memorandum, above n 3, [1.17].

involves trying to identify if activities are stand alone businesses that are separate from other business activities that are grouped under a broader umbrella of activity. In turn, the need to separate business activities will also require the difficult process of apportioning profits and expenses between various business activities when applying, for example, the above discussed four threshold tests.⁴⁵

As the Explanatory Memorandum acknowledged, identifying if activities are in fact separate will require difficult questions of fact and degree.⁴⁶ Yet no guidance is provided in the legislation and this has again required clarification through a public ruling. To this end *Taxation Ruling 2001/14* [37] states that an activity that forms part of a taxpayer's overall business will not be treated as a separate business activity for Division 35 purposes unless it is 'capable of standing alone as an autonomous commercial undertaking.' *Taxation Ruling 2001/14* [41] states that it is also necessary that the separate business activities are 'capable in their own right of producing assessable income and having attributed to them amounts that would otherwise be deductible.' *Taxation Ruling 2001/14* [43] further states:

[T]o be identified as a separate business activity for Division 35, within the statutory scheme referred to, the activity (or set of activities) will need to exhibit the following:

- (i) it produces a loss, in the sense that looked at as a separate activity there is clearly assessable income produced, or intended to be produced, from it, and otherwise allowable deductions attributable to carrying it on in excess of that income (otherwise Division 35 has no relevance);
- (ii) its conduct is not motivated by factors connected with supporting in any commercial way the carrying on of the individual's other business activities; and
- (iii) it shows signs in its own right that it is unlikely to ever be profitable.

The application of these factors is clearly going to be complex and uncertain.⁴⁷ The ATO's *Non-commercial losses: similar business activities - fact sheet* regards the following activities as similar:

- grazing sheep and grazing cattle;
- growing grapes and growing olives;
- manufacturing shirts and manufacturing jeans.⁴⁸

Activities that are said to be dissimilar:

- manufacturing and farming;
- repairing cars and making furniture.⁴⁹

Ultimately, *Taxation Ruling 2001/14* [41] states that whether the business activities are so discrete in character and conducted in such a manner so that they are considered to be separate and distinct business activities for Division 35 purposes is a 'question of fact and overall impression, like the question whether they are carrying on a business.' Thus the ruling recognises that Division 35 has added another layer to an already complex question 'whether the taxpayer is carrying on a business,' discussed below.

V GROUPING ACTIVITIES

While generally Division 35 is concerned with the profits and losses etc of a

⁴⁵ Douglas, above n 26, 389.

⁴⁶ See also Explanatory Memorandum, above n 3, [1.18]-[1.19].

⁴⁷ See also Douglas, above n 26, 389; Cooper, above n 26, 162.

⁴⁸ NAT no 3384-05.2003 www.ato.gov.au.

⁴⁹ Ibid.

particular business activity,⁵⁰ this is further complicated because at times the legislation allows business activities to be grouped under s 35-10(3). Grouping can be advantageous to a taxpayer. First, it allows the overall enterprise, comprised of grouped activities, to be adjudged in terms of size and profitability under the four threshold tests, thereby possibly excluding the operation of the loss deferral rule.⁵¹

Second, it may be advantageous in terms of identifying the 'next income year in which the activity is carried on' under s 35-10(2). As noted above, deferred losses can be offset against future income. The grouping rules may bring forward the next qualifying financial year in which the deferred loss can be offset against income. The activity that makes the profit in the later year of income need not be the same activity as that which made the non-commercial loss if they are grouped because they are of a similar kind.⁵² Thus, as a consequence of the grouping effect of s 35-10(3), that future income can stem from a grouped activity.

Third, grouping will also be advantageous where a business activity ceases. The taxpayer will continue to be able to offset the loss in the future as long as the taxpayer carries on a business activity of a similar kind.⁵³ As discussed above, without continuing a similar business activity the deferred loss would otherwise effectively be forfeited.

The s 35-10(3) grouping principle necessitates some determinative factor as to what activities are grouped. Under s 35-10(3) separate and distinct business activities may be grouped where they are of a similar kind. A grouped activity does not have to be 'of the same kind', just 'of a similar kind'.⁵⁴

This begs the question what is sufficiently 'similar'? This is clearly an amorphous notion that has again necessitated the 'intervention' of a public ruling. *Taxation Ruling 2001/14* [50] states as relevant factors:

- the location(s) where they are carried on;
- the type(s) of goods and/or services provided;
- the market(s) conditions in which those goods and/or services are traded;
- the type(s) of assets employed in each; and
- any other features affecting the manner in which they are conducted.

The application of the similar kind test will also depend on how broadly or narrowly each of the business activities is construed. The broader in nature the distinct business activities, the more likely they will have the same or similar characteristics.⁵⁵ As the existing jurisprudence regarding the notion 'normal proceeds'⁵⁶ of a business under s 6-5 *ITAA 1997* indicates, there is great uncertainty as to when a court will broadly⁵⁷ or

⁵⁰ See also Explanatory Memorandum, above n 3, [1.17].

⁵¹ See also *Taxation Ruling 2001/14*, above n 3, [53] and [119]-[122].

⁵² See also *ibid* [49], [91] and [130]-[131].

⁵³ See also *ibid* [54].

⁵⁴ See also *ibid* [49] and [85].

⁵⁵ See also *ibid* [52]. See further *ibid* [51]-[53], [85]-[87] and [119]-[129].

⁵⁶ *Californian Copper Syndicate (Limited and Reduced) v Harris* (1904) 5 TC 159, 165-166; *Australasian Catholic Assurance Co Ltd v FCT* (1959) 100 CLR 502, 509; *FCT v Merv Brown Pty Ltd* (1985) 85 ATC 4080, 4086.

⁵⁷ For examples of the broad approach see *Ducker v Rees Roturbo Development Syndicate Ltd* (1928) 13 TC 366; *MacKenzie v Arnold* (1952) 33 TC 363; *Jeffrey v Rolls-Royce Ltd* (1962) 40 TC 443; *J Hammond Investments Pty Ltd v FCT* (1977) 77 ATC 4311; *Kosciusko Thredbo Pty Ltd v FCT* (1984) 84 ATC 4043; *Jennings Industries Ltd v FCT* (1984) 84 ATC 4288; *Memorex Pty Ltd v FCT* (1987) 87 ATC 5034; *FCT v Marshall and Brougham* (1987) 87 ATC 4522; *FCT v Cooling* (1990) 90 ATC 4472; *GP International Pipecoaters Pty Ltd v FCT* (1990) 90 ATC 4413; *FCT v GKN Kwikform Services Pty Ltd* (1991) 91 ATC 4336; *Case 22/95* (1995) 95 ATC 243; *Rotherwood Pty Ltd v FCT* (1994) 94 ATC 4514; (1996) 96 ATC

narrowly⁵⁸ construe a business. The breadth of the business activities and determining whether they are similar is clearly going to be an uncertain question of fact and degree, determined on a case-by-case basis.

VI PARTNERSHIPS

As noted above, the application of Division 35 is particularly complicated in the context of partnerships. Division 35 applies in relation to ‘individual taxpayers’, whether acting alone or in partnership: s 35-10(1). The consequent complications stem from two core features of Division 35’s application to partnerships. First, as stated in *Taxation Ruling TR 2003/3*, for the purposes s 35-10(2) it is not the partnership as a whole that is examined, but rather the individual partner’s interests in each business activity.⁵⁹ Thus, as discussed below, the application of Division 35 involves more than a consideration of the net partnership income under s 90 *ITAA 1936*.

Second, the application of Division 35 becomes complex when the individual carries on multiple business activities in a partnership. As a consequence of the need to separate and isolate various business activities,⁶⁰ discussed above, the application of Division 35 also involves more than a consideration of an individual partner’s interest in partnership income under s 92 *ITAA 1936*.⁶¹ The complexities involved as a consequence of these principles is highlighted below in the application of the four threshold tests and the primary production and professional arts business exceptions to partnerships.

A Assessable Income Test

The application of the assessable income test to a partnership is overly complex. The assessable income is that part of the assessable income from the business activity for the year that is attributable to the interest of a partner who is an individual in the partnership net income or partnership loss for the year: s 35-25(b). Under s 35-25(a) the taxpayer may include that part of the partnership’s assessable income attributable to other partners who are individuals, including the taxpayer’s own share.⁶² In addition to the amount identified under s 35-25(b) any part of the assessable income from the business activity for the year that is derived from the activity by the individual taxpayer otherwise than as a member of the partnership is included in the assessable income: s 35-25(b).

4203; *Case 18/96* (1996) 96 ATC 237; *Case 16/98* (1998) 98 ATC 209; *Case 18/96* (1996) 96 ATC 237; *Esso Australia Resources Ltd v FCT* (1997) 97 ATC 4371; 98 ATC 4768; *FCT v Montgomery* (1999) 99 ATC 4749; *O’Connell v FCT* (2002) 2002 ATC 4628; *Proctor v FCT* (2005) 2005 ATC 2132.

⁵⁸ For examples of the narrow approach see *Collins v Firth-Brearley Stainless Steel Syndicate Ltd* (1928) 13 TC 366; *Case K20* (1978) 78 ATC 184; *Kwikspan Purlin System Pty Ltd v FCT* (1984) 15 ATR 531; *FCT v Merv Brown Pty Ltd* (1985) 85 ATC 4080; *FCT v Cyclone Scaffolding Pty Ltd* (1987) 87 ATC 5083; *FCT v Spedley Securities Ltd* (1988) 88 ATC 4126; *Westfield Ltd v FCT* (1991) 91 ATC 4234; *FCT v Hyteco Hiring Pty Ltd* (1992) 92 ATC 4694; *Lees & Leech Pty Ltd v FCT* (1997) 97 ATC 4407; *Selleck v FCT* (1997) 97 ATC 4856; *CSR v FCT* (2000) 2000 ATC 4215.

⁵⁹ *Taxation Ruling TR 2003/3*, above n 3 [5], [13] and [19].

⁶⁰ See also *ibid* [6] and [19].

⁶¹ *Ibid* [5].

⁶² Explanatory Memorandum above n 3, [1.32].

B Profits Test

The application of the profits test is also complicated in the context of partnerships. The profits test is satisfied if for each of at least three of the past five income years, (including the current year) the sum of the individual partner's deductions attributable to the activity (including his or her share of the partnership deductions) is less than the sum of the individual partner's assessable income (including his or her share of the partnership's assessable income) from the activity for that year: s 35-35(2).⁶³ Indicative of the complexity of this rule in the example provided in *Taxation Ruling TR 2001/14*:

Bob and Brendan are partners in a general law partnership which carries on a publishing business and they each receive a \$2,000 distribution from it. Bob has no other attributable expenses and the result for him is a profit from the business activity for the income year. ... Brendan took out a loan to fund his contribution to the partnership on which he pays interest of \$5,000 during the year. Brendan's \$5,000 interest expense is attributable to his interest in the partnership net income. Brendan's deductions that are attributable to the activity (\$5,000) exceed the income he has derived from it (\$2,000). Brendan has a loss for the income year from the activity. If this pattern of income and attributable expenses were to continue for a further two years (years 2 and 3), with the partnership distributing losses to Bob and Brendan in years 4 and 5, Bob would pass the Profits test in years 4 and 5, as when testing for each of those years he would have profits from the activity in three out of the past five years (ie, years 1 to 3); whereas Brendan would not pass the Profits test in any of the five years, as even in the years in which he received a distribution of partnership income, his attributable expenses meant that overall he did not make a tax profit from that activity in any year.

Thus the example highlights the complexities that stem from focusing on individual partners, rather than the partnership as a whole. Here we have a single business, but two different outcomes for the two partners.

C Real Property and Other Assets Tests

Applying the real property test to partnerships is also complicated. When calculating the reduced cost bases of real property or interests in such, the following amounts only are included:

- any part of the reduced cost bases or other values of assets of the partnership used in carrying on the activity in that year that is attributable to the partner's interest in those assets: s 35-25(c); and
- any part of the reduced cost bases or other values of assets owned or leased by the individual taxpayer that are not partnership assets but are used in carrying on the activity in that year: s 35-25(d).

The interests in companies and trusts are ignored.⁶⁴

Similarly, when calculating the value of other assets, only the following amounts are included:

- any part of the reduced cost bases or other values of assets of the partnership used in carrying on the activity in that year that is attributable to the partner's interest in those assets: s 35-45(4)(c); and
- any part of the reduced cost bases or other values of assets owned or leased by the individual taxpayer that are not partnership assets but are used in carrying on the activity in that year: s 35-45(4)(d).

Again, the interests in companies and trusts are ignored.⁶⁵

⁶³ See also *Taxation Ruling TR 2001/14*, above n 3, [29].

⁶⁴ *Ibid* [28].

D Primary Production and Professional Arts Business Exceptions

As the application of the primary production business exception, noted above, is particularly complicated in regard to partnerships and it is primarily addressed in this context. Under s 35-10(4), the loss deferral rule does not apply to a business activity for an income year if:

- the business activity is a primary production business; and
- the taxpayer's assessable income for that year (except any net capital gain) from other sources that do not relate to that activity is less than \$40,000.

The rationale for this exemption is straightforward. As the Explanatory Memorandum states this is to assist 'primary producers who find it necessary to support themselves through moderate amounts of farm income (particularly in periods of hardship), while genuinely, at the same time, seeking to pursue their farm activities on a commercial basis.'⁶⁶ Once again, however, the devil's in the detail. Leaving aside the particular application to partnerships, the exception requires the complex task of identifying a primary production business. Thus, in addition to the complexities involved in identifying a business, discussed below, there is the need to identify that the relevant business is one of primary production.

Importantly in this context, again, the application of this exemption is complicated in the case of partnerships. Where the loss making business activity is conducted by the individual taxpayer outside a partnership and the other source of income is partnership income or the loss making business activity is conducted by the partnership but the other source of income is not partnership income, the operation of s 35-10(4) is relatively straightforward. However, in the context of partnerships conducting multiple business activities the application of the legislation is difficult. Where the loss making business activity and the other source of income are both within the activities of the same partnership, the legislative exemption effectively requires a separating of business activities within the partnership and in turn the identification of the income from any unrelated partnership business activities and that of the loss making primary production business activities.⁶⁷ In turn the calculation of partnership net income under s 90 *ITAA 1936* and a partner's interest in such under s 92 *ITAA 1936* cannot simply be used to determine the application of s 35-10(4).⁶⁸

The complexity of the application of these principles is reflected in the example provided in *Taxation Ruling TR 2003/3* [59]-[63]:

59. David and Mary operate a camping supplies store and a cattle grazing business together in a partnership. They share profits and losses equally. The following income and expenses result from these two separate business activities for the 2001-02 income year:

	Camping Store	Cattle Grazing
Assessable Income	\$100,000	\$10,000
Allowable Deductions	\$35,000	\$47,000
Profit / Loss	\$65,000	\$(37,000) loss
Net income of partnership	\$28,000	

60. As in Examples 1(a) and (b) above, subsection 35-10(2) applies by looking at each individual partner's share of the assessable income and the allowable deductions for each

⁶⁵ Ibid [28] and [143].

⁶⁶ Explanatory Memorandum, above n 3.

⁶⁷ See also *Taxation Ruling TR 2003/3*, above n 3 [39].

⁶⁸ See also *ibid* [38]-[39].

business activity carried on in the partnership. Consequently, there is no amount which can be deferred by subsection 35-10(2) in respect of the camping supplies store, but each partner may have to defer \$18,500 (50% of (\$37,000)) each in respect of the cattle grazing business activity.

61. Subsection 35-10(4) provides an Exception to the operation of subsection 35-10(2), where a primary production business activity is being carried on and the assessable income (excluding any net capital gain) from sources which do not relate to this activity is less than \$40,000.

62. Whilst the net income of the partnership is \$28,000, and each partner's interest in that net income is \$14,000, the figure of \$14,000 does not provide a true reflection, for the purposes of subsection 35-10(4), of what is their 'assessable income from other sources' that are unrelated to the loss making (cattle grazing) activity.

63. The proper calculation of the amount of assessable income from these other sources, in this case the camping store, is carried out by disregarding the assessable income from, and the allowable deductions attributable to, the loss making (cattle grazing) activity. This gives rise to each partner's share of the net income in respect of the camping store being \$32,500 (50% of \$65,000). This is below the \$40,000 prescribed in paragraph 35-10(4)(b), and hence the Exception in subsection 35-10(4) does operate to prevent the loss deferral rule in subsection 35-10(2) applying.

The example says it all – the devil's in the detail.

As noted above, a further exception to the loss deferral rule applies where the business activity is a professional arts business and the taxpayer's assessable income for that income year (except any net capital gain) from other sources that do not relate to that activity is less than \$40,000 for an income year: s 35-10(4). Leaving aside for the moment the uncertainty of the notion of a 'business', discussed below, and in turn the notion of a 'professional arts business',⁶⁹ the application of this exception is most complicated in the case of partnerships. Again, where either the loss making business activity is conducted by the individual taxpayer outside the partnership and the other source of income is partnership income or the loss making business activity is conducted by the partnership but the other sources of income is not partnership income, the operation of s 35-10(4) is relatively straightforward. However, where the partnership conducts multiple business activities, the application of s 35-10(4) is more complex. Again, where the loss making business activity and the other source of income are both within the activities of the same partnership, this exemption requires the income from any unrelated partnership business activities and that of the loss making professional arts business activities to be separated.⁷⁰ Again, it is not simply a matter of using the net partnership income under s 90 *ITAA 1936* and the partner's interest in such under s 92 *ITAA 1936*.

⁶⁹ Under s 35-10(5) a 'professional arts business' is a business that an individual carries on as (i) the author of a literary, dramatic, musical or artistic work; (ii) a performing artist; or (iii) a production associate. However, these terms are not defined in *ITAA 1997*. Rather, the expression 'author', for example, is stated to be a technical term derived from copyright law: s 35-10(5)(a) Note. However, the *Copyright Act 1968* does not define who is an author of a musical work. See also *Taxation Ruling TR 2001/14* *ibid* [89]. Thus we must turn to the common law definition of 'author' which, according to *Taxation Ruling TR 2001/14* *ibid* [89], provides that the author is the person who has 'originated it or brought it into existence and has not copied it from another.' See further the discussion of such complexities in *Taxation Ruling TR 2005/1*. Note, *ATO Interpretative Decision ID 2004/468* states that the manager or agent of a professional artist is not considered to be conducting a professional arts business.

⁷⁰ *Taxation Ruling TR 2003/3* [39].

VII COMMISSIONER'S DISCRETION

As noted above, under s 35-55 the Commissioner has discretion in certain cases to allow a taxpayer to offset losses from the business activity even if the business activity does not satisfy any of the above four threshold tests in an income year. This discretion is primarily designed to ensure that the loss deferral rule does not adversely impact on taxpayers who have commenced carrying on a business activity that by its nature requires a number of years to produce assessable income: s 35-10(1)(a) Note.⁷¹ While the rationale for the provision is reasonably straightforward, again the devil's in the detail. As discussed below, the incorporation of this discretion makes the operation of Division 35 highly complicated and uncertain.

The prerequisites for the Commissioner's discretion are quite complicated. The Commissioner may exercise the discretion in regard to one or more income years,⁷² if he or she is satisfied that it would be unreasonable to apply the rule in three circumstances. First, the discretion may be exercised where the business activity was or will be affected by special circumstances outside the taxpayer's control. The notion of 'special circumstances' is not, however, exhaustively defined in Division 35. Only an inclusionary definition in terms of drought, flood, bushfire or some other natural disaster is included in 35-55(1)(a). Once again this has led to the necessity of a public ruling clarifying the matter. *Taxation Ruling TR 2001/14* [70] states that special circumstances will not be dependent upon the government declaring a natural disaster. Moreover, the ruling notes there is nothing in the legislation that specifically confines special circumstances to natural disasters. The ordinary meaning⁷³ of the words is wide enough to include other circumstances of a special nature. To this end *Taxation Ruling TR 2001/14* [71] lists further examples of 'special circumstances':

- a chemical spray drift;
- a gas plant explosion;
- a power plant shutdown;
- a water authority malfunction;
- government authority restriction imposed on land use; or
- other events such as the illness of the taxpayer or employee(s) which have significantly affected the ability of the operator to carry on the business activity.

The ruling states at [72] that while ordinary economic or market fluctuations that might reasonably be predicted will not constitute 'special circumstances', substantial and unexpected economic or market fluctuations might be so considered. Undoubtedly the vagueness of the notion of 'special circumstances' will lead to case-by-case litigation.

Moreover, the discretion involves proof of a causal connection. The special circumstances must be the reason for failing to meet one of the four threshold tests. Thus in *Farnan v FCT*⁷⁴ the taxpayer unsuccessfully argued that the Commissioner should have exercised his discretion not to defer the loss from his driving instruction business. The special circumstance the taxpayer suggested that had impacted on his business was the closure of one of the high schools where he made business

⁷¹ See also Explanatory Memorandum, above n 3 [1.53].

⁷² The discretion can be applied for each year that the special circumstances have hampered one of the four threshold tests being satisfied: *Taxation Ruling TR 2001/14*, above n 3, [73], [147]-[153] and [156]-[157].

⁷³ See *Secretary, Department of Employment, Education, Training and Youth Affairs v Barrett* (1998) 82 FLR 524.

⁷⁴ (2005) 2005 ATC 2093.

presentations. The Tribunal rejected the argument on the basis that there was no evidence that, but for the closure of the high school, the taxpayer would have met any of the threshold tests.

Second, the discretion may be exercised where the business activity has started to be carried on and because of its nature it has not yet satisfied one of the threshold tests: s 35-55(1)(b). Once again, the rationale for this discretion appears simple. It is designed to ensure that the loss deferral rule does not apply to taxpayers who have commenced carrying on business activities which by their very nature take a number of years to produce assessable income: s 35-55(1)(b) Note. For example, the legislation notes that a business activity involving the planting of hardwood trees for harvest would require many years before it could reasonably be expected to produce income: s 35-55(1)(b) Note. The Explanatory Memorandum notes as examples of activities that could fall into this category forestry, viticulture and certain horticultural activities.⁷⁵ However, again the devil's in the detail.

This discretion requires that (i) the business activity must be 'carried on' and (ii) it is the nature of the business that dictates that one of the four threshold tests has not been met. In regard to the first requirement, the taxpayer must have commenced carrying on the activity. *Taxation Ruling TR 2001/14* [75] and [97] states that this will generally require that the individual has (i) made a decision to commence the business activity, (ii) acquired the minimum level of business assets needed to carry on the activity and (iii) actually commenced 'business operations.' A mere intention to commence a business will not suffice.⁷⁶ Thus preliminary and preparatory activities will be excluded from the scope of the discretion. As the relevant case law dealing with this issue in the context of s 8-1 *ITAA 1997* indicates, determining whether activities are preparatory or preliminary can be a complex question.⁷⁷

As to the second prerequisite, it must be the nature of the business activity that leads to a failure to meet one of the four threshold tests. This in turn requires considerable specificity as to the cause underlying the failure to satisfy the tests. First it must be the nature of the particular industry, rather than the taxpayer's competency, that leads to the failure to derive, for example, the required assessable income. In *FCT v Eskandari* the court in turn emphasised that s 35-55 does not apply if the business has failed because the taxpayer is 'incompetent or lazy.'⁷⁸ There must be something innate or inherent in the business activity itself that means there is lapse in commencement and the production of assessable income: s 35-55(1)(b) Note.⁷⁹

Second, in *FCT v Eskandari* the court asserted that s 35-55(1)(b)(i) requires that it must be the nature of the particular industry, rather than the nature of the taxpayer's business, that causes the initial lack of income.⁸⁰ In turn the court said this requires that the essential features that are common to business activities of the same kind or class as the taxpayer's business are the cause for the failure to meet the four threshold tests.⁸¹ This approach led to the relevant taxpayer failing to make his case, the court

⁷⁵ Explanatory Memorandum, above n 3, [1.50] – [1.51].

⁷⁶ *Taxation Ruling TR 2001/14*, above n 3, [75] and [100].

⁷⁷ See *Southern Estates Pty Ltd v FCT* (1967) 117 CLR 481; *Dalton v FCT* (1998) 98 ATC 2025; *Case 75/96* (1996) 96 ATC 677; *Vallambrosa Rubber Co Ltd v Farmer* (1910) 5 TC 529; *Softwood Pulp & Paper Ltd v FCT* (1976) 76 ATC 4439; *Goodman Fielder Wattie Ltd v FCT* (1991) 91 ATC 4438.

⁷⁸ (2004) 2004 ATC 4042, 4048.

⁷⁹ *Taxation Ruling TR 2001/14* above n 3, [76], [108]-[109], [154] and [168]. See also paragraph Explanatory Memorandum above n 3 [1.51]; *Taxation Ruling TR 2001/14* above n 3 [77], [105]-[113], [154]-[155] and [165]-[170].

⁸⁰ (2004) 2004 ATC 4042, 4048-4049.

⁸¹ (2004) 2004 ATC 4042, 4048-4049.

reasoning that the taxpayer's failure to satisfy the relevant test was based on the taxpayer's particular fee structure, rather than an aspect of the nature of migration agencies in general.⁸² Again this is undoubtedly going to lead to further cases where it is uncertain whether it is the nature of the industry or the taxpayer's conduct of the particular business activity that is the underlying cause of the failure to meet one of the threshold tests.

The third basis for the exercise of the discretion is where there is an objective expectation, based on evidence from independent sources, where available, that the business activity will either pass one of the four threshold tests or produce a profit within a period that is commercially viable for the industry concerned: s 35-55(1)(b)(ii). The rationale is obvious. Again it is intended to cover a business activity that has a lead time between the commencement of the business activity and the production of any assessable income. Planting of hardwood trees for harvest, where many years would pass before the activity could reasonably be expected to produce income, is provided as an example: s 35-55(1)(b)(ii) Note. Further, examples of such activities would be 'forestry, viticulture and certain horticultural activities.'⁸³

The exercise of this discretion requires the taxpayer to take on the burden of proving that there is an objective expectation that the threshold tests will be met in time.⁸⁴ In a given case, this may be quite a heavy burden of proof. While the Explanatory Memorandum states that the objective expectation must be based on information from industry bodies or scientific research,⁸⁵ the reference in the legislation to 'where available' indicates that in many cases objective evidence from independent sources will not be available.⁸⁶ As the court recognised in *FCT v Eskandari*:

In some cases it may be a straightforward exercise to identify the industry in which the business activity takes place. Some industries are well-established and the basis for an 'objective expectation' can readily be based on a comparison between the taxpayer's business and other businesses within that industry, particularly where businesses or business associations within the industry produce material such as annual reports or industry papers. In other cases the business activity may exist in an industry that is difficult to identify because of the innovative nature of the business or the undeveloped nature of the industry. There may, because of the nature of the industry, be very little or no independent source material. In such circumstances it will, as an evidentiary matter, be more difficult for the taxpayer to discharge the burden imposed by s 14ZZK(b)(iii) of the *Taxation Administration Act 1953* (Cth) and convince the Commissioner that the requirements for the exercise of its discretion have been met. It may be necessary to refer to the circumstances of the taxpayer. Forming an objective expectation in such cases requires an extrapolation from those circumstances taking into account the nature of the relevant business activity, the costs or losses incurred and an estimated duration for the start-up phase. Ultimately, however, this question, including the meaning of a 'commercially viable period', is one of fact that is for the Tribunal to decide, and only where the Tribunal's decision constitutes an error of law will it be reviewable by this Court.⁸⁷

As stated in *FCT v Eskandari*, it is also necessary to prove that with that type of business activity, after meeting certain requirements, it will be a commercially viable

⁸² (2004) 2004 ATC 4042, 4050. See also *Kennedy v FCT* (2005) 2005 ATC 2098, 2107.

⁸³ Explanatory Memorandum above n 3, [1.53].

⁸⁴ *FCT v Eskandari* (2004) 2004 ATC 4042, 4051- 4052; *Kennedy v FCT* (2005) 2005 ATC 2098, 2107.

⁸⁵ Explanatory Memorandum above n 3, [1.50]. Independent sources would include 'industry bodies or relevant professional associations, government agencies, or other taxpayers conducting successful comparable businesses': *Taxation Ruling TR 2001/14* above n 3, [81].

⁸⁶ See also *FCT v Eskandari* (2004) 2004 ATC 4042, 4051.

⁸⁷ (2004) 2004 ATC 4042, 4052.

business, not that the taxpayer's particular business will become commercially viable.⁸⁸

Further, under s 35-55(2) the Commissioner must not exercise the discretion after the time that it would be reasonable to expect the activity to first produce a profit or to pass one of the four above discussed threshold tests.

Finally, the process involved in activating an exercise of discretion is also relatively complicated. A taxpayer must apply for a private ruling under s 359-10 *Taxation Administration Act 1953* (Cth), supported by a completed, *ATO Application for private ruling on the exercise of the Commissioner's discretion for the Non-commercial business losses form*.⁸⁹ As Kenny notes, this is a lengthy form that requires detailed information about the business activity, supported by documentation.⁹⁰

VIII BUSINESS ACTIVITY

As is already apparent from the above discussion, the devil in Division 35 is not always in the detail, but the lack thereof. This is particularly apparent in a core part of Division 35. As detailed above, Division 35 is not intended to apply to activities that do not constitute the carrying on a business, for example, the receipt of income from passive investments: s 35-5(2). To this end the focus of Division 35 is on businesses carried on by individuals as 'business activities': s 35-10. Thus as *Taxation Ruling 2001/14* [56] affirms, the relevant assessable income must be 'derived directly from, and has a causal relationship with, the carrying on of that business activity for the income year in question.'⁹¹

Despite the importance of the notion of 'business' and in turn 'business activity' these terms are not defined in Division 35. Moreover, the Act does not define the terms except through the general, unhelpful definition of 'business' in s 995-1 *ITAA 1997*. Section 995-1(1) *ITAA 1997* defines 'business' as including 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee.' As the definition is inclusionary, it provides little assistance in identifying a business.⁹² Its main use lies in excluding persons who derive income as employees in the sense of a master and servant relationship, rather than being self-employed.⁹³

The absence of a definition of 'business activity' in Division 35 is particularly peculiar given the *Ralph Report* noted:

The law in relation to carrying on a business is very difficult and resource intensive to administer and must be done on a case-by-case basis. The need to apply the existing law on that basis does not permit the efficient and effective use of resources and creates uncertainty. A systemic solution that better deals with losses arising from such non-commercial activities is warranted.⁹⁴

The failure to define a business activity means that the application of Division 35 includes the difficult question what is a 'business'. In turn this will mean the application of Division 35 necessitates a reversion to the existing plethora of cases

⁸⁸ (2004) 2004 ATC 4042, 4051.

⁸⁹ www.ato.gov.au/downloads/n5806-12-2005.pdf.

⁹⁰ Kenny above n 26.

⁹¹ See further *Taxation Ruling 2001/14*, above n 3, [91]-[92] and [134]-[136].

⁹² *Ferguson v FCT* (1979) 79 ATC 4261, 4264; *Case X31* (1990) 90 ATC 296, 298.

⁹³ *Partridge v Mallandaine* (1886) 2 TC 179, 180.

⁹⁴ *Ralph Report*, above n 1, 296. See also Explanatory Memorandum, above n 3, [1.7]-[1.9]; *Taxation Ruling TR 2001/14* above n 3 [8] and [38].

relevant to, *inter alia*, s 8-1 ITAA 1997, as to what is a 'business' and thus necessitate a case-by-case determination of such. This is indicative from the Division 35 cases that are starting to trickle through the courts. For example, in *Kennedy v FCT* the Tribunal concluded that the taxpayer's documentary film production activities were for pleasure, rather than a business, and thus Division 35 could not apply.⁹⁵ Indicative of this confusion there are further public rulings on this aspect of Division 35, such as *Draft Taxation Ruling TR 2004/D14* as to when a business of a professional artist is being conducted.

Effectively, Division 35 adds another layer of complexity to the existing jurisprudence pertaining to the notion of a 'business' which the *Ralph Report* recognised is a highly uncertain and resource intensive part of taxation law.⁹⁶ It is ultimately contended that it would have been preferable for the legislature to have introduced a statutory definition of income that focuses on the common indicia of these hobby style activities identified in the *Ralph Report*, quoted above; namely they are 'unlikely to ever make a profit and do not have a significant commercial purpose or character.'⁹⁷ Preferable to the complexity of Division 35 would have been a statutory definition of business that required (i) a reasonable prospect of making a profit and (ii) a profit making intent. This reform proposal would reflect the key judicial indicia of a business, namely the existence of a profit making intent.⁹⁸ This statutory definition would, however, involve a legislative overruling of a line of jurisprudence that provides that it is not necessary for activities to constitute a business that there be a realistic potential for the activities to make a profit as long as the taxpayer intends to make a profit and diligently pursues that object.⁹⁹ A statutory definition of business would have addressed the policy concerns expressed in the *Ralph Report* and simplified the notion of 'business'.

IX CONCLUSION

Once again a simple concept has been masticated by detail. Perhaps what is worse is that Division 35 is riddled with a blend of too much and too little detail. Despite the *Ralph Report's* recognition of the complexity of existing legal notions, such as 'business', this is not subject to legislative definition and many other key terms in Division 35 are not defined. Further revision of Division 35 is clearly needed. A statutory definition of business would alleviate much of the *Ralph Report* concerns for revenue leakage, while simplifying existing jurisprudence.

⁹⁵ (2005) 2005 ATC 2098, 2107.

⁹⁶ *Ralph Report* above n 1, 296. See also Explanatory Memorandum, above n 3, [1.7]-[1.9]; *Taxation Ruling TR 2001/14* above n 3, [8] and [38].

⁹⁷ *Ralph Report* *ibid*. See also Explanatory Memorandum *ibid*; *Taxation Ruling TR 2001/14* *ibid*.

⁹⁸ *Smith v Anderson* (1880) 15 Ch D 247, 258; *Ferguson v FCT* (1979) 79 ATC 4261, 4264-4265; *FCT v Solling*; *FCT v Pepper* (1985) 85 ATC 4518, 4531; *Evans v FCT* (1989) 89 ATC 4540, 4554-4555; *FCT v Radnor Pty Ltd* (1991) 91 ATC 4689, 4700; *Case 47/96* (1996) 96 ATC 463, 468; *Case 75/96* (1996) ATC 677, 682; *Daff v FCT* (1998) 98 ATC 2129, 2134.

⁹⁹ *Tweddle v FCT* (1942) 7 ATD 186; *Thomas v FCT* (1972) 72 ATC 4094; *Case H11* (1976) 76 ATC 59; *Case M67* (1980) 80 ATC 479; *Daff v FCT* (1998) 98 ATC 2129, 2135.

TAXATION OF ILLEGAL ACTIVITIES IN NEW ZEALAND AND AUSTRALIA

RANJANA GUPTA*

The article explores the gaps that exist with regard to the taxation of illegal activities in New Zealand and Australia and the impact of proposed legislative reform on the application of constructive trusts in the area of taxation. It sets out the tests applied by the Courts to determine whether an illegal activity is taxable. The paper shows that while some criminal activities are taxable others are not.

The author then considers the deductibility of expenses, particularly fines imposed by the Courts, incurred through criminal activity. The judiciary and the Commissioner of Taxation have relied upon a number of arguments to deny deductibility of expenses that would otherwise appear to meet the general statutory test for deductibility. In the absence of a clear statutory prohibition the paper attempts to establish a guide on which expenses should be deductible. The author hopes that this will serve as a guide in the event of future disputes in the area.

I INTRODUCTION

Taxation, in theory, knows no morality.¹ The Commissioner of Taxation will tax any income within the scope of the Income Tax Act and allow any deductions within the scope of the Act. It is not, in theory, an issue of fairness but of statutory application and that is the same for the taxpayer earning income from criminal activities which constitute business as it is of the ordinary legitimate taxpayer.

Does the broad approach of equality before the Income Tax Act actually exist in practice? Are all illegal activities taxable? Is a career burglar taxable on the proceeds of his activity? As will be discussed, not all illegal activities are taxable even though at first glance, it might appear so.

Income tax applies to increases in economic capacity (i.e. income as defined by case law) and applies equally to all increases in ability to pay.² Expenses incurred in deriving assessable income are deductible.³ There are two conceptual issues to consider in determining whether the doctrines make any sense in terms of taxation principles. First, do we want to tax illegal profits more harshly than other profits to discourage the activity? Secondly, do we want to use tax law to reinforce criminal law or do we want to distinguish illegal profits that the criminal might have to return? In the latter case we would treat profits as the equivalent of untaxed loans or borrowed funds on the basis that the criminal has no true claim to keep them.

Following on from this introduction, the scope of illegal enterprise within the New Zealand and Australian economy and as an element of the tax base is explored in Part 2. The paper considers the distinction between the treatments of the income from illicit activities, compared to the income earned by ordinary taxpayers in Part 3. It

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¹ Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part IV: Operational Issues, Ch 16: Relationship with Taxpayers. The two features of a benchmark income tax are horizontal equity and vertical equity.

² A Smith, *An Inquiry into the Nature and Causes of Wealth of Nations*, Chicago, Encyclopaedia Britannica, 1952, at p 362. Adam Smith's four canons of taxation are generally taken to include equity.

³ Income Tax Act 2007 (ITA 2007), s DA 1.

provides an overview of the application of the ordinary concepts of income to illicit activity. There is particular reference to relevant New Zealand and Australian cases. Cases from other jurisdictions are also examined to determine if indeed the application of the ordinary concepts of income to illicit activity does exist. Part 4 of the paper considers the distinguishing characteristics of illegality, reviewing the possible contribution of incidental illegality and property rights applied by the courts to determine whether an illegal activity is taxable. There is particular reference to *A Taxpayer v CIR*,⁴ an embezzlement case which held the criminal was technically not subject to tax and resulted in a statutory reform. The next part of the paper sets out the deductibility of expenses, particularly fines imposed by courts. It considers tax precedents and principles of income tax for deduction, reviewing several approaches taken by courts to deny deductibility: illegality severing deductibility on a quasi-capital basis, public policy reasons, and treating fines as private expenditure. It also examines the Commissioner's approach to the deductibility of fines and concludes that the deductibility of fines is not analogous to the treatment of income from illegal activities. Part 6 includes a summary of the key tests covered in the article and suggests that in New Zealand and Australia, in the absence of unified test for deductions, a more consistent approach would be achieved by simply applying the statutory test more rigorously.⁵

II THE SCOPE OF ILLEGAL PROFITS IN NEW ZEALAND AND AUSTRALIA

Dr P Caragata⁶ identified a number of models to estimate the size of the hidden economy in New Zealand. According to Dr Caragata's figures from his preferred model the average size of the hidden economy during 1969 to 1994 was 8.8per cent of gross domestic product (GDP).⁷ However when those figures are broken down into distinct time periods the annual average for the hidden economy as a part of GDP is increasing: in 1990 to 1994 it was 9.5% and in 1994 alone it was 11.3per cent. This equates to approximately \$7.1 billion. Caragata believes that these figures are "conservative".⁸

Those figures relate to the hidden economy and that concept is not identical to the illicit or illegal economy. The hidden economy represents economic activity that is not covered by conventional statistics and includes both illegal activities and tax evasion. Tax evasion refers to an activity that, in itself, is not illegal but is being conducted knowingly to evade the incidence of tax.⁹ Examples include undisclosed cash payments for goods and services¹⁰ or under the counter payments to employees.

⁴ *A Taxpayer v CIR* (1997) 18 NZTC 13,350.

⁵ ITA 2007 s DA 1; s 8-1 of the Income Tax Assessment Act 1997 (ITAA97)

⁶ PJ. Caragata, *The Economic and Compliance Consequences of Taxation: A Report on the Health of the Tax System in New Zealand*, Boston, Kluwer Academic Publishers, 1998.

⁷ This compares well with other countries and put New Zealand's hidden economy at the lower end of the scale. The estimates range from approximately 27 per cent of GDP for Italy to 6 per cent of GDP for Switzerland for 1994. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.21: Tax Evasion and the Hidden Economy.

⁸ An accurate estimate of the hidden economy is, by its very nature, unlikely to be obtained but estimates can vary markedly between observers depending upon the country concerned, the availability of data and the method employed in estimating it. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.22: Tax Evasion and the Hidden Economy.

⁹ *Taylor v Attorney-General* [1963] NZLR 261 (SC).

¹⁰ It includes income from prostitution. Prostitution is legal in New Zealand.

This type of behavior is referred to by Caragata as "soft core" hidden economic activity and represents behavior entered into predominantly to escape the incidence of tax. The illegal economies, or the "hard core" hidden economy, are activities that are not disclosed because undertaking them is in itself illegal e.g. illegal gambling, drug dealing, white-collar crimes, theft and frauds. I shall refer to this as the illicit economy.

Therefore, when considering the extent of illicit economic activity, this must be distinguished from the wider concept of the hidden economy. In the model adopted by Caragata, where there is a zero per cent tax rate the hidden economy is only 40% of its former size.¹¹ According to Caragata the illicit economy is approximately 4.52% of GDP or \$2.84 billion per year when using the 1994 figures. Caragata suggests that theft and fraud constitute 70 per cent of the illicit economy and that therefore approximately 3.8 per cent of GDP relates to theft and fraud, making this type of activity the major source of illegal profits. He suggested that theft and fraud constitutes 70% of the illicit economy. This conclusion seems to ignore that the balance of GDP he attributes to the illicit economy is less than one per cent (representing the level of illegal income from drug dealing, prostitution,¹² illegal gambling, poaching, money-laundering, people-smuggling and any other potential source of illegal income). However, Caragata relies upon an interpolation from United States figures and defines his conclusion as no more than a suspicion; therefore, it is submitted that the breakdown suggested by Caragata may be less than accurate.

During May 2006 a report on Observance of Standards and Code prepared by Financial Task Force Action stated that Australian Government estimate suggested that the amount of money laundering in Australia ranges between AUD 2-3 billion per year.¹³ It is a starting point that indicates the monetary importance of the illicit economy to the tax base within New Zealand and Australia. While it can be accepted that indirect taxation is more efficient in attaching itself to the illegal income,¹⁴ it is unlikely that the Government will abolish direct taxation in its favour. Indeed, Caragata advocates directing more resources into auditing criminals¹⁵ as the dollar return from such audits is so high. Accepting that such activity is worth pursuing from a revenue gathering perspective, this raises the question of whether or not it can be so pursued but a discussion of this issue is beyond the scope of this paper.

¹¹ The significance of that is that, with a zero percent tax rate there is no incentive to enter into tax evasion – there is no tax to be evaded. Therefore the remaining hidden economy must be the illegal economy, hidden for reasons other than taxation. The 40 percent remaining is the natural underground economy.

¹² The Prostitution Reform Act 2003 governs the rules when or where an individual sex worker may work for the business of prostitution, which has now been legalised.

¹³ International Monetary Fund, *Australia: Mutual Evaluation Report - FATF Recommendations for Anti-money Laundering and combating the financing of Terrorism* (Report No. 06/424, November 2006).

¹⁴ Income from the illegal economy will eventually be returned to the ordinary economy, otherwise it is rendered of negligible value, GST will be payable upon that application of hidden income. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.17: Tax Evasion and the Hidden Economy.

¹⁵ P Caragata, "Tax Evasion: What the Tax System Health Report Really Said" (1998) 42:14 *Current Taxation* 27.

III ILLEGAL PROFITS AND ORDINARY PROFITS

Australian and New Zealand common law, is based on the doctrine of precedent. The challenge for the courts is to find the most appropriate precedent to the facts in hand. The concept of the "transplanted category" – using concepts from one area of law to interpret another area of law (tax law in this case) - sometimes yield results that are inappropriate in terms of the policy objectives underlying the recipient body of law.¹⁶ The British legislation was, and remains, in a schedular format: what constitutes income is determined by its source; if it has a source within the Income Tax Act it is income.¹⁷ Therefore, British developments must be considered in the context of a different tax base.

The fundamental question is whether there is any logical distinction between the treatments of the income from illicit activities, compared to the income earned by ordinary taxpayers.

The legislation is of no help here. Australian Income Tax Assessment Act 1997(Cth)(ITAA 1997) and New Zealand Income Tax Act 2007 (ITA 07) includes provisions specifically dealing with how the victims of theft should manage the taxation consequences of the loss and how property in the hands of a criminal should be defined for tax purposes.¹⁸ In Australia Tax Ruling 93/25 (1993)¹⁹ deals with the taxation of illegal businesses. Parsons suggests, "an item of an income character is derived when it has 'come home' to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation".²⁰ The principles which determine the derivation of an item express a general concept of realisation as essential to income derivation. Where the item results in an increase in the value of property it would be possible to regard the increase as unrealised gain.²¹ According to accrual based accounting, income is generally considered to be earned when the taxpayer has a legal right to receive payment,²² but for an illegal activity where purported contracts would not be enforceable, the taxpayer would not have a legal right of payment and therefore in practice only cash accounting could operate. Parsons²³ suggests that a claim of right, rather than legal entitlement may be sufficient for derivation of income.

A Taxability of Illegal Profits

The taxability of illegal profits relies upon the application of the ordinary concepts of income to the illicit activity, in short, ascertaining whether or not there

¹⁶ R Krever, "Taming Complexity in Australian Income Tax" (2003) 25:4 *Sydney Law Review* 467.

¹⁷ J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in A J Oakley (ed), *Trends in Contemporary Trust Law*, Clarendon Press, Oxford, 1996 at p 315.

¹⁸ ITA 07, ss DB 42, CB 32 and cases *Gold Band Services Ltd v CIR* [1961] NZLR 467, *W G Evans & Co Ltd v CIR* (1976) 2 NZTC 61,080, and *Case K39* (1988) 10 NZTC 129.

¹⁹ ATO, Income tax: Assessability of proceeds from illegal activities, treatment of amounts recovered and deductibility of fines and penalties.

²⁰ RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd., 1985, Proposition 1 at para 2.7.

²¹ *Ibid* at paras 2.10 – 2.29. A detailed discussion of principles of ordinary income can be found especially in chapter 2.

²² *J Rowe and Barratt v Federal Commissioner of Taxation* (1992) 92 ATC 4275.

²³ RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd., 1985, at Para 2.7.

is a business being undertaken. In *Partridge v Mallendaine*,²⁴ one of the earliest cases to consider the taxability of illegal income, where the legislation was silent as to the legality or illegality of the activities, unlawful businesses were not to be given the advantage of being free from income tax.

In *Minister of Finance v Smith*,²⁵ a case involving an illegal business, namely bootlegging, the Privy Council considered that the position of an activity of illicit traffic in liquor which was illegal under a particular Canadian province's law but which could potentially have been carried out legally under other provinces' laws (it was not in itself a criminal offence under common law – only an illegal activity under statute). Viscount Haldane held that the power of the Dominion Legislature to impose income tax would not be limited by provincial law declaring an activity illegal.

The public ruling issued by Australian Tax office states that 'receipts from a systematic activity where the elements of a business are present are income irrespective of whether the activities are legal or illegal'.²⁶ In New Zealand the courts have had little difficulty in accepting that the proceeds of illegal activities are taxable. There have been numerous cases dealing with the calculation of assessable income as a result of illicit activities such as drug dealing and bookmaking.²⁷ There have been other cases dealing with the Commissioner's debt recovery powers where the debt arises, in part, from illegal proceeds²⁸ and with the Commissioner's powers²⁹ to request information regarding a taxpayer's illicit activities to enable an assessment to be made.³⁰ However, there has been little authority of the basis upon which such proceeds are, taxable. This appears to have been taken for granted with one judge simply saying, in response to a submission illegal profits are not taxable: "[I]t would be an absurd situation should the Commissioner be unable to assess income simply because a taxpayer's activities were illegal."³¹

²⁴ *Partridge v Mallendaine* (1886) 2 TC 179 at p 181, where Justice Denman said, "In my opinion if a man was to make a systematic business of receiving stolen goods, and to do nothing else, and he thereby systematically carried on a business and made a profit of £2,000 a year, the Income Tax Commissioners would be quite right in assessing him as if it were in fact his vocation. There is no limit as to its being a lawful vocation, nor do I think that the fact that it is unlawful can be set up in favour of these persons as against the rights of the revenue to have payment in respect of the profits that are made."

²⁵ *Minister of Finance v Smith* [1927] AC 193.

²⁶ Taxation Ruling 93/25, 5. TR 93/25, 2 states any activity not permitted by law, such as drug dealing, insider trading, misappropriation, prostitution and SP bookmaking is illegal activity. Some of these activities may no longer be illegal under the relevant State or Territory legislation.

²⁷ *Case T2* (1997) 18 NZTC 8,007; *Case F146* (1984) 6 NZTC 60,283; *Case D57* (1980) 4 NZTC 60,852; *Case B3* (1975) 2 NZTC 60,020; and *Case Z23* 92 ATC 235.

²⁸ *Yee v CIR* (1988) 10 NZTC 5,258. The taxpayer's default assessment was based on estimated profits from heroin trafficking. The taxpayer subsequently used his motor vehicle as security pursuant to an instrument by way of security against the money owed under the default assessment. The security was given on some implied basis that the Commissioner would not demand the tax owing or exercise the security if proper returns were filed within a reasonable time. According to the Commissioner satisfactory returns had not been filed therefore, the CIR could realise a security of the taxpayer given to him.

²⁹ Tax Administration Act 1994, s 81.

³⁰ *Wojcik v Police* (1996) 17 NZTC 12,646. An illegal search and seizure by police did not stop the Commissioner from being able to use a taxpayer's seized property as the basis for making an assessment.

³¹ *Case D 57* (1980) 4 NZTC 60,852, per Judge Lloyd Martin, Taxation Review Authority. The taxpayer was convicted on charges of possessing and selling heroin. In the decision the comment was made that it was quite immaterial as to whether a business or other income was legal or illegal. The Court's analysis of the actions of taxpayer was premised on the notion that they amounted to business.

However, it could not be said that the proceeds from all forms of illegal activity have been consistently treated as taxable. For example, the proceeds of burglary have for a long time been considered, at least in dicta, as not taxable.³² However, *Southern v AB Ltd* case and *Lindsay v CIR* case the decision commented that burglary was not a trade. As will be discussed, the proceeds of embezzlement have been determined to be not assessable in New Zealand.³³ The courts have considered whether an activity is a trade or a business as a recognisable basis for the differing treatments of the proceeds of differing types of illegal activity.

The early cases stress that the taxability of the proceeds of illegal activity arises because of the scope of taxation legislation. In one of the few such cases to reach the Privy Council,³⁴ their Lordships grounded their decision that the proceeds of illegal alcohol exports were taxable on the ordinary principles of taxation.

In New Zealand and Australia courts have based their decision regarding taxability of illegal incomes on the normal tests of whether or not there is a business activity: in effect the *Grieve*³⁵ and *Walker*³⁶ test of a business activity applied evenhandedly to any activity. Australian Tax Ruling stated: "What is normally accepted as income is determined according to ordinary usages and concepts of mankind. Receipts from a systematic activity where the elements of a business are present are income irrespective of whether activities are legal or illegal".³⁷ If this is the case the exceptions become less easy to understand. No one commits a fraud or theft without intending to benefit from that action. It seems illogical to levy taxation on a drug

³² *Southern v AB Ltd* [1933] 1KB 713 at 719; *Lindsay v CIR* [1932] 18 TC 43.

³³ *A Taxpayer v CIR* (1997) 18 NZTC 13,350. It is noted that the majority at the Court of Appeal open their judgment defining the issue as 'the taxation consequences of engaging in criminal activity for financial gain.' This, it is submitted, is too wide a formulation of the particular issue before the Court. The issue was merely the tax treatment of the proceeds of embezzlement and not all forms of criminal endeavor as Tipping J recognised commencing his judgment: 'the issue in this case is whether a thief as liable to pay income tax on the moneys stolen'.

³⁴ *Minister of Finance v Smith* [1927] AC 193 at 197 per Viscount Haldane:

Nor does it seem to their Lordships a natural construction of the Act to read it as permitting persons who come within its terms to defeat taxation by setting up their own wrong. There is nothing in the Act which points to any intention to curtail the statutory definition of income, and it is not appropriate under the circumstances to impart any assumed moral or ethical standard as controlling in a case such as this the literal interpretation of the language employed.

Also see *Southern v AB Ltd* (op cit) and *Mann v Nash* [1932] 1 KB 752 at 758 per Rowlatt J, 'The revenue authorities ... are merely looking at an accomplished fact. It is not condoning it, or taking part in it. It merely finds profit made from what appears to be a trade, and the revenue laws say that profits made from a trade are to be taxed'.

³⁵ *Grieve v CIR* (1984) 6 NZTC 61,682 at 61,689. See also at 61,691 where Richardson J said:

It follows from this analysis that the decision whether or not the taxpayer is in business involves a two-fold inquiry – as to the nature of the activities carried on, and as to the intention of the taxpayer in engaging in those activities. Statements by the taxpayer as to his intentions are of course relevant but actions will often speak louder than words. Amongst the matters which may properly be considered in that inquiry are the nature of the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results. It may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those which are characteristic of ordinary trade in the line of business in which the venture was conducted. However, in the end it is the character and the circumstances of the particular venture which are crucial. Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture. Nor because that business is illegal.

³⁶ *Federal Commissioner of Taxation v Walker* (1985) 85 ATC4179. The court identified number of tests to determine whether a taxpayer was carrying on a business but nowhere in these tests is there a requirement that the activities undertaken be legal.

³⁷ ATO Tax Ruling 93/25 (1993) at [5].

dealing transaction but not on the selling of stolen goods.³⁸ Both are conducted with a view to making a profit (regardless of what motivates that profit). The white-collar criminal will be no less organised than a thief (and probably a good deal more effective as a criminal). An illegal activity, if not engaged in with an intention to make profit and with sufficiently regularity to be a 'business', may not be taxable, even if profitable, as it is more akin to a hobby, the gains derived from which are not subject to income tax.

IV DISTINGUISHING CHARACTERISTICS

A Incidental Illegality

Whether or not the illegality is at the heart of a transaction may determine assessability of the activity.³⁹ Theft is of its very nature illegal and would never be considered otherwise whereas some illegal activities such as the resetting of stolen gems in jewellery⁴⁰ or the sale of liquor⁴¹ could be pursued legitimately. By this approach "illegality goes to the root of the transaction so that it is incapable of being a trade under any circumstances whatsoever, whereas in the example of resetting stolen gems the illegality may only be an incident of the trade, leaving out any consideration of any contravention of the law".⁴²

Part of the problem may arise from the nature of the British legislation against which these earlier cases were determined. The British legislation determines income by its source; therefore need to identify a legitimate parallel "trade" become more understandable. When considering an activity which is not illegal per se, the illegality of the components of that activity or the illegality of particular transactions may be ignored in determining the overall profits earned. However when the activity as a whole is illegal, that activity is not within the notion of a trade or business as contemplated by the relevant legislation.

In my view, this reasoning seems unconvincing. In essence this approach requires the identification of a parallel legal activity to which the illegal one can be compared to determine assessability. For example in the *Lindsay* case Lord Sands gives the illustration of drug trafficking saying: "Trafficking in drugs, for example, is of the nature of trade, albeit such trafficking may in the circumstances be illegal".⁴³ Because there is a legal activity of drug sales, profits from illegal drug dealing can be assessed. Therefore the test of incidental illegality is to identify a similar or identical legal business, if this can be done the activity is taxable. In the *La Rosa*⁴⁴ case the taxpayer was involved in drug dealing. In 1996 he was sentenced to more than 12 years in prison, after pleading guilty to charges relating to the importation

³⁸ *Lindsay v IR Commrs* [1932] 18 TC 43. In *Lindsay* Lords Clyde said (at p 54), 'a distinction seems to be drawn between illegal or unlawful but commercial activities and crime'. In *Lindsay* Lords Clyde and Morison considered that persons reselling stolen goods or committing burglaries would not per se, from those activities alone, be assessable for income tax. Their Lordships agreed that if the proceeds of their crimes were used in business the profits of that business would be assessable income.

³⁹ K Day, "The tax consequences of illegal trading transactions", (1971) *British Tax Review* 104.

⁴⁰ *Lindsay v IR Commrs* [1932] 18 TC 43 – where this example was developed.

⁴¹ *Minister of Finance v Smith* [1927] AC 193; *Lindsay v IR Commrs* [1932] 18 TC 43..

⁴² K Day, "The tax consequences of illegal trading transactions" (1971) *British Tax Review* 104 at p 108.

⁴³ *Lindsay v IR Commrs* [1932] 18 TC 43. .

⁴⁴ *CIR v La Rosa* (2003) 53 ATR 1.

and possession of heroin.⁴⁵ Francesco Dominico La Rosa forfeited personal property, real property and money valued at \$264,610 under the *Proceeds of Crimes Act 1987*. It came to the Commissioner's attention that the taxpayer had not lodged income tax returns for seven years from 1990 to 1996 inclusive. Accordingly, the Commissioner issued default notices of assessment⁴⁶ to the taxpayer for the relevant years, including interest and penalties.⁴⁷ The first three years' assessments were based on the default assessment provision, with the first three years based on averaging income derived in previous periods where returns have been furnished and the final four years' assessment were based on the 'T' accounts provided to the Commissioner by the Commonwealth Director of Public Prosecutions.⁴⁸

In *LA Rosa* case since there is a legitimate parallel to drug sales, profits from illegal drug dealing were assessed. However, it appears from the earlier cases that the usual test of business activity, in practice, is not used when faced with illegal activities. A burglary ring can be very well organised; intended to make a profit and actually achieve a profit and yet may not be a business as there is no legitimate parallel to theft. In the *Lindsay* case⁴⁹ the manufacturing and sale of liquor was legal in Scotland, but the sale to Prohibition America was illegal. The activity was able to be conducted domestically without any illegality but could not be carried out between two countries without breaking the laws of both jurisdictions. This illegality did not prevent assessability as illegality was not of essence in trading in rye whisky. While profits from an illegal activity amounting to a trade will constitute assessable income from a trade, not all criminal activities will amount to a trade, of course. Whether an illegal activity amounts to a trade will depend on the ordinary tests used by courts to identify trades.

In *Southern v AB Ltd* Finlay J commented as follows:

I express no opinion upon a case which is quite unlike the case which is before me, but I desire to point out exactly why, assuming as I am quite willing to assume, the burglar does not come within the purview of the Income Tax Acts: if he does not come within the purview of the Income Tax Acts, it is because what he does is not the carrying on of a trade within Case I, and

⁴⁵ *La Rosa v The Queen* (1999) 105 A Crim R 362,363.

⁴⁶ Pursuant to s 167 of the Income Tax Assessment Act 1936 (Cth).

⁴⁷ The Commissioner of Taxation issued him with a tax debt of \$960,000.

⁴⁸ To determine the appropriate amount of income to be assessed some adjustments were made to the T accounts prepared by the Commonwealth Director of Public Prosecutions in determining the appropriate amount to be assessed. Refer to *CIR v La Rosa* (2002) 50 ATR 450 at 453.

⁴⁹ *Lindsay v IR Commrs* [1932] 18 TC 43. at pp 54-55. The Lord President (Clyde) went on to distinguish between illegal or unlawful but commercial activities and crime:

There are many transactions which are illegal in the sense that the obligations upon which they depend are not such as the law will enforce...I do not, however, think that, merely because the contract was not enforceable by law, profits actually made by the partnership's trading operations must necessarily be placed beyond assessment to Income tax as profits of 'trade'....It is plain enough, I think, that the profits of crime could not be assessable to Income Tax as the profits of trade. If – to take an example – the mode of living followed by an individual consisted of nothing – or practically nothing – but the commission of the crime of re-setting stolen goods, it might be difficult to say that the profits were assessable to Income Tax as the profits of 'trade'---

In *Lindsay* Lord Sands stated: (at p 56): 'Crime, such as housebreaking, is not trade, and therefore the proceeds are not caught by tax...' In *Lindsay* in the words of Lord Morison (at p 58): 'A question was raised as to whether the profits or gains of a burglar were subject to tax. Obviously not, because burglary is not a trade or business'.

it is not because, carrying on a trade within Case I, he is taken out by some considerations of morals or anything of that sort.⁵⁰

It seems illogical that an incidental illegal profit is fully taxable, whereas one that is wholly illegal is not.⁵¹ This approach is not followed in New Zealand except to the extent that specific legislative intervention has occurred.⁵²

However, in New Zealand the Income Tax Act taxes gains in the nature of income, itself undefined⁵³ and generally authorities look for some link between receipt and activity of a taxpayer that parallels the British concept of trade. But there is an additional twist in New Zealand where the courts distinguish between proceeds of a trade (illegal or legal) that are derived absolutely by a taxpayer and those to which the taxpayer has only a tentative claim because of their illegal nature (and the fact that they will have to be returned if the taxpayer is caught). In this approach it is the nature of the receipt in the hands of the taxpayer that determines taxability, not its source. But the same distinctions are broadly maintained. An apposite case is that of *A Taxpayer*.⁵⁴ The Court of Appeal determined that the proceeds of embezzlement were not income to the thief. Therefore, there is a need to investigate the reasons for that treatment.

B Property Based Distinctions

It is submitted that the broad distinguishing characteristic is property right rather than legal activity parallels. In the case of illicit gambling, drug dealing, and prostitution there are no prior property rights being abused or ignored. In the case of most forms of commercial poaching,⁵⁵ theft, fraud and embezzlement, there are clear prior property rights that the criminal intends to defeat by his or her actions. Rather than determining whether that illegality is incidental to the activity being conducted, in my submission, it is the lack of a property right that distinguishes one form of illegality from another for taxation purposes.

The case of *A Taxpayer* offers an example of this approach. In that case an accountant systematically embezzled over \$2 million from his employer, which he used to speculate in the futures market. Unfortunately his future trading was not successful and he made losses. Eventually he was caught and had to repay the funds embezzled, of which he could repay only half. The Commissioner assessed him on

⁵⁰ *Southern v AB Ltd* [1933] 1KB 713at p 727. The taxpayer, AB, and his company AB Ltd, carried on an illegal bookmaking (street betting and ready money betting) business. Finlay J was of the opinion that the activities constitute a trade notwithstanding the fact that they involved illegality.

⁵¹ K Day, "The tax consequences of illegal trading transactions", (1971) *British Tax Review* 104,115 - 116; as per s 25-15 of ITAA 1997 the proceeds of crime to be ordinary income, and therefore subject to income tax, the criminal activities must amount to business.

⁵² ITA 2007, s CB 32, referred to at paragraph 4.3 of this paper.

⁵³ ITA 2007, s CA 1:

CA 1 Amounts that are income

Amounts specifically identified

(1) An amount is income of a person if it is their income under a provision in this Part.

Ordinary meaning

(2) An amount is also income of a person if it is their income under ordinary concepts.

⁵⁴ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA); *Case W27 89 ATC 280* at 287 and *FCT v Elton* 90 ATC 4,078 where a fraudulently negotiated cheque was not considered to be income by either party.

⁵⁵ This is true, it is submitted, of the most common poaching in New Zealand; over-fishing of quota. There is no property right in the fish prior to the over-fishing but there is a breach of the regulations making the over-fishing illegal.

the funds stolen and income from his trading activities but did not allow a deduction for the trading losses. The taxpayer objected and a case was stated.

In the Taxation Review Authority,⁵⁶ Judge Willy found in favour of the taxpayer because he considered the money stolen to be circulating capital in the hands of the taxpayer rather than income. This conclusion is questionable, as it seems to determine the assessability based upon the application of the funds rather than its character upon receipt.⁵⁷ His Honour also considered that the futures trading activity was a business and that the losses should have been allowed. This latter finding is not surprising and the Commissioner has advanced no logical reason why the profits from that activity were taxable but the losses not deductible. The issue of the accountant's property in the funds stolen was not discussed.

The Commissioner appealed to the High Court solely on the issue of the assessability of the stolen funds.⁵⁸ The issue of ownership of the funds was argued before Morris J. The taxpayer argued that the funds were received subject to an obligation to repay the amount stolen and therefore were in the nature of a loan, albeit involuntary. The Commissioner canvassed numerous Canadian and American decisions regarding the quality of stolen funds in the hands of the taxpayer⁵⁹ to argue the taxability of such money is not affected by an obligation to repay the money or any concept of a constructive trust.⁶⁰

In equity constructive trust arises at the time the thief commits the act that obligates him or her to account to the rightful owner of the property. This equitable remedy ensures that the thief does not acquire beneficial ownership of the property stolen. It is the lack of constructive trust that distinguishes the property interests involved for different form of illegal activities. In case of simple theft a thief has no fiduciary duty as compared to a case of embezzlement where there is existence of fiduciary duty on the part of the embezzler which results in a constructive trust.

In reaching his decision Morris J implicitly accepted the reasoning used in the Canadian and American cases:

The respondent was under an obligation to return the stolen money. For the monies that he did return no question of taxation arises. The remaining money he converted to his own use. While he is still liable in law to account for the monies, he is taxable on them because he was in effect holding and using the money for his own account. He is obliged to return the money because of the manner in which he acquired it. He is taxable on the money because of the manner in which he held it. His duty to return the money is a separate issue to the question of taxation. While he is not the strict legal owner of the money he is holding it for his own use. The reality of the situation is that the respondent regarded the money as his own to use for his purposes as he chose. I therefore, conclude that the stolen monies do constitute income and are assessable for income tax.⁶¹

This approach equates to the North American concept of the claim of right. The doctrine of claim of right would allow the Commissioner to ignore any issues of

⁵⁶ Case Q3 (1993) 15 NZTC 5,033.

⁵⁷ RJ Wallace, "Taxation of the Proceeds of Embezzlement" (1996) 2(4) New Zealand Journal of Taxation Law and Policy 201 at p 202.

⁵⁸ CIR v A Taxpayer (1996) 17 NZTC 12,574 at p 12,578

⁵⁹ R v Poynton [1972] CTC 411(embezzlement by manager of a construction society using false invoices); and James v US (1961) 366 US 213 (Union official embezzling from the union and an insurance company). See also Curlett v MNR [1991] CTC 338; and Buckman v MNR [1991] 2 CTC 2,608 (solicitor embezzled clients money when repaid by borrowers).

⁶⁰ In equity a constructive trust arises at the time the thief commits the act that obliges him or her to account to the rightful owner of property. This equitable remedy ensures the thief does not acquire beneficial ownership of the property stolen.

⁶¹ CIR v A Taxpayer (1996) 17 NZTC 12,574 at 12,578.

restitution or constructive trust and to tax the funds stolen as a gain to the thief. In the words of Morris J:

When a person receives money, whether it's lawful or not, if there is no consensual recognition of a right to repay, then income has been received even if it must be repaid. The receiver has had the benefit of the money so must pay tax on it.⁶²

This would mean a person could be taxed on gains even if they have no right to ownership of the gain. Glover stated that the claim of right doctrine basically imputes beneficial ownership in the thief or embezzler for taxation purposes.⁶³

The Court of Appeal⁶⁴ decided in favour of the taxpayer. The Court rejected any reliance upon the North American cases,⁶⁵ preferring an Australian case⁶⁶ as more consistent with the usual approach to determining whether or not a gain has been made. The Court of Appeal rejected any reliance upon the economic reality of the situation and based its decision upon the application of property and trust concepts. Referring to *Arthur Murray (NSW) Pty Ltd v C of T*⁶⁷ the majority at the Court of Appeal said:

The Court obviously considered that sums received subject to a trust or charge did not have the quality of income derived by the recipient. In principle, an embezzler is liable to return or repay the stolen property and the innocent party to embezzlement retains the right to trace the property or its proceeds into the hands of the embezzler.⁶⁸

Again referring to *Arthur Murray (NSW) Pty Ltd v C of T* the Court Appeal it in the *Taxpayer* case decided that:

The embezzler does not have any claim of right to the stolen property. In the absence of a specific statutory provision allowing for a recharacterisation or different characterisation of the misappropriation receipt for tax purposes, the ordinary rules apply. Legal rights and obligations cannot be ignored. There is no gain to a taxpayer unless the receipt is derived beneficially by the taxpayer. Taxation by economic equivalence is impermissible (*CIR v Europa Oil (NZ) Ltd* [1971] 1 NZLR 641, 648; *Europa Oil (NZ) Ltd v CIR* (No 2) [1976] 1 NZLR 546, 552 [also reported at (1976) 2 NZTC 61,066, 61,071; (1976) 1 TRNZ 369, 376]).⁶⁹

Therefore, if Morris J derived implicit support from the doctrine of claim of right, it has been expressly rejected by Richardson P, Keith and Elias JJ at the Court of

⁶² *CIR v A Taxpayer* (1996) 17 NZTC 12,576.

⁶³ J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in A J Oakley (ed), *Trends in Contemporary Trust Law*, Oxford, Clarendon Press, 1996, 315 at p 322.

⁶⁴ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA).

⁶⁵ Except for the dissenting judgment of Black J in *James v US* (1961) 366 US 213.

⁶⁶ *Zobory v FCT* (1995) 30 ATR 412. (Taxpayer embezzled money from employer. Returned the interest made by investing that money but had to repay the stolen funds and interest earned to the employer. The Court directed FCT to accept his amended returns excluding the interest.) This case is not without its critics: see Glover, above n 62, and RJ Wallace, "Taxation of the Proceeds of Embezzlement", (1996) 2 (4) *New Zealand Journal of Taxation Law and Policy* 201 at p 202. However it was relied upon in *Norilya Minerals Pty Ltd v Cmr of State Taxation (WA)* (1995) ATC 4,559 where it was said (at p 4,566):

Once it is established that the circumstance of fraud surrounding the payment of the money was such as to cause it to be held ... on constructive trust for the [taxpayer], it is clear that the [taxpayer] has simply retained the beneficial interest in the money and it is abundantly clear that in the circumstances of this case the trust would arise immediately upon the payment secured by the false pretence...

The case went on to accept that the tracing was available; as the taxpayer's beneficial interest had not been defeated by the fraud of the criminal.

⁶⁷ *Arthur Murray (NSW) Pty Ltd v C of T* (1965) 114 CLR 314 where the High Court of Australia found that sums for pre-paid dance lessons could not be considered income until the services for which the sums were paid were performed.

⁶⁸ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,358.

⁶⁹ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,359.

Appeal. That rejection was firmly based on the ordinary approach of income being a benefit to the person receiving it and not subject to some other beneficial interest. This reflects the importance of property when determining whether receipt is income. Parsons⁷⁰ identifies that there is no gain unless the receipt is beneficially derived by the taxpayer and the Court of Appeal's approach in *A Taxpayer* is consistent with this concept.

Issue has been taken to this approach by at least one commentator.⁷¹ Glover argues that the sole concern of Inland Revenue is the assessing of a gain in the hands of the taxpayer and there is no need to concern itself with issues of property right. However, it is submitted that the gain to the taxpayer needs to be identified by reference to the usual tests of property rights rather than simply accruing any sum received as a gain. No one would seriously contend that a sum borrowed is a taxable gain; economically the sum is a gain but it is subject to counterbalancing obligation to repay the sum, which prevents it being a gain for income tax purposes.⁷² In *Hadlee and Sydney Bridge Nominees Ltd v CIR*⁷³ the taxpayer was a partner in an accounting firm where the partnership agreement provided the profits to be given to partners in proportion to the number of units of partnership capital held by them. The taxpayer transferred certain of his partnership units to a discretionary family trust. Glover points to *Hadlee and Sydney Bridge Nominees Ltd*⁷⁴ as an example of courts ignoring a beneficial interest to determine the taxpayer had a gain. But the Privy Council did treat the income subject to a family trust as a gain to the settlor because the assignment of income was not effective to remove the benefit from the settlor prior to its receipt by the trust.

Therefore, it is passing of beneficial ownership that determines, in part, whether a receipt is taxable as the approach in *A Taxpayer*⁷⁵ confirms. Thus the proceeds of drug trafficking, gambling and poaching can be seen to be beneficially derived by the taxpayer (and thus taxable), whereas the proceeds of burglary or embezzlement are not beneficially derived (whether as a result of a constructive trust or a right of restitution) and therefore not taxable.

Consequently the application of ordinary concepts of property rights is a component in determining whether or not the taxpayer has received a gain. It is submitted that this offers a more consistent test to determining which taxable activities give rise to assessable income than the "incidental illegality" test. The issue of whether the "degree" of illegality of the activity giving rises to the gain becomes irrelevant. A completely illegal activity in which property rights in gain pass, without reservation to a criminal will be taxable (for example gambling) whereas a gain in which no property passes to the criminal will not be considered a gain at all and therefore not taxable (for example fraud, theft or burglary).⁷⁶ On this basis determining legitimate parallel

⁷⁰ RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd., 1985, at para 2.27 and paras 2.41- 2.44.

⁷¹ J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in A J Oakley (ed), *Trends in Contemporary Trust Law*, Oxford, Clarendon Press, 1996, at p 322.

⁷² *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at p 13,359.

⁷³ *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993)15 NZTC 10,106 (PC).

⁷⁴ *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993)15 NZTC 10,106 (PC).

⁷⁵ *A Taxpayer v CIR* (1997) 18 NZTC 13,350.

⁷⁶ The newspaper publisher may have to give up all his profits if it turns out he sold papers by writing stories that defamed people. The manufacturer may have to give up profits if it turned out that he entered into an illegal monopolistic agreement. The retailer may have to give up profits if it turns out the goods or services were not as promised and there is a price adjustment or refund. If we took this "claim of right" idea to its limit, we'd tax nothing.

activity is unnecessary.

C Statutory Reform

Following the Court of Appeal ruling in *A Taxpayer*⁷⁷ that unless stolen money was made subject to income tax by express provision it was not taxable, the Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill 1998 was introduced. To protect the tax base the bill proposed amendment to the Income Tax Act 1994 by including within the meaning of "gross income" property obtained without colour of right. The main purpose of the proposed amendment was to prevent people from evading income tax by recharacterising their income as stolen. The officials' report on the bill stated that the taxation of stolen property in no way provides a legal sanction to theft or like conduct. The report stated that the taxation of stolen property can be justified on the basis that by not taxing it, the tax system is in effect subsidising those who choose to steal property.

Following on from this Parliament enacted an amendment to make the proceeds of embezzlement, fraud, misappropriation and theft taxable by inserting section CB 32 of the ITA 2007.⁷⁸ Although this is inconsistent with the common law treatment discussed above,⁷⁹ the Court of Appeal recognised the need for statutory authority to make stolen funds income.⁸⁰ It can not be doubted that Parliament has the authority to cut across any constructive trust or possibility of restitution imposed by the operation of equity, which the section expressly does at CB 32(3).⁸¹ In making such an amendment Parliament can be taken to have considered the underlying public policy issues and determined that the taxability of the gain in the hands of the criminal overrides any restorative property reservations that equity would impose on the receipt of the sum.

This reform would enable the treatment of stolen funds to be more consistent with other provisions in the Act. For example, the victims of embezzlement are able to deduct the losses resulting from the theft as a result of the ITA 2007 s DB 42.⁸² Any recoupment is deemed to be gross income derived by the victim in the income year in which the amount is recouped. However, if the constructive trust is imposed, as the Court of Appeal found, there has been no loss to the victim, as the victim is entitled absolutely to beneficial ownership.

Under section HC 6 of the ITA 07 beneficiary income, under a trust, is income that

⁷⁷ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA).

⁷⁸ Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Act 1998 inserted s CD 6 of the ITA 94 and it takes effect from 1 April 1995. This is somewhat later than the initially proposed date of 1st April 1989 and reflects a general repugnance of retrospectivity. As per s CB 32 of the ITA 07 (equivalent to s CD 6 of the ITA 94 and s CB 28 of the ITA 04) gross income of a person is deemed to include the market value of misappropriated property without colour of right of which that person has obtained possession or control. Under s 219(1) of the *Crimes Act* 1961 and in s YA 1 of the ITA 07, "claim of right" means, in relation to any act: "... a belief that the act is lawful, although that belief may be based on ignorance or mistake of fact or of any matter of law other than the enactment against which the offence is alleged to have been committed". It should also be noted that there is a corresponding deduction for any restitution made of stolen funds at s DB 44 ITA 07 (equivalent to s DJ 18 of ITA 94 and s DB 35, ITA 04). This is broadly consistent with the American approach: see *Chicago RI & PR Co. v CIR* 47 F 2nd 990 at 992. Colour of right was replaced with claim of right from 1 October 2003.

⁷⁹ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) and *Arthur Murray (NSW) Pty Ltd v C of T* (1965) 114 CLR 314.

⁸⁰ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at p 13,355.

⁸¹ Equivalent to s CD 6 (2) of the ITA 94; and s CB 28(3) of the ITA 04.

⁸² Equivalent to s DJ 8 of the ITA 94 and s DB 33 of the ITA 04.

"vests absolutely in interest" in the beneficiary which is consistent with the amendment. This phrase is undefined by the Act but in an explanatory statement on the trust regime the Commissioner stated that:

Income vests in a beneficiary where the beneficiary obtains an immediate fixed right of present or future possession of the income. Thus, income vests absolutely in interest in a beneficiary if the beneficiary obtains an immediate right to possession of the income.⁸³

The constructive trust approach would mean the victim could find him or herself taxable on income they have not in reality received but because of the constructive trust are deemed to be entitled to and is consistent with s H 6 of the ITA 07. Interest derived from the investment of embezzled funds though received by embezzler would be treated as income of the beneficiary of the constructive trust. This does seem an illogical (and somewhat unfair) result. The statutory reform⁸⁴ would prevent the application of a constructive trust in the taxation treatment of such sums. The existence of constructive trust has prevented the taxation of the amounts as income of the embezzler in Australia. Celeste Black 'submitted that the adoption of similar provision in Australia would be advantageous as it clarify simplify tax obligations where there is a subsequent finding that a constructive trust has arisen'.⁸⁵

As has been argued if the determination of taxable income is based on ordinary principles⁸⁶ it is necessary to consider the deductibility of expenses, in particular fines and penalties, to see whether ordinary principles have been applied in order to determine deductibility.

V DEDUCTIBILITY OF FINES AND COURT COSTS

Section 8-1 ITAA97 and s DA 1 of the ITA07⁸⁷ states that any expenditure or loss, including a depreciation loss, incurred in deriving assessable income or in the course of carrying on a business for the purpose of deriving assessable income is deductible. The normal test for general expenses deductibility should be determined on a nexus test, that is the deductibility of a given expense is determined by its relationship to the earning of income or the business of earning income. It remains one of the canons of taxation law that it be applied without reading in any intention, i.e. simply relying on the ordinary meaning of the relevant words.⁸⁸ There are several limitations under four negative limb of s 8-1ITAA97 and s DA 2 ITA 07, each of which overrides the general permission. There are provisions under s DA 3 of ITA 07 which supplement the general permission and that allows a person a deduction without requiring satisfaction of the general permission. In some circumstances that supplement, and not

⁸³ Inland Revenue, "Appendix" (1989) 1(5) *Tax Information Bulletin* 32.

⁸⁴ Section CB 32(3) of the ITA 07 only applies to the thief not the victim. *James v United States*, 366 US 213 (1961) (S C) Amounts received by way of embezzlement were held to be taxable income and provides authority for this approach. Claim of right doctrine as developed, income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.; *R v Poyton* (1972) CTC 411 and *Buckman v Minister of National Revenue* (1991) 2 CTC 2608.

⁸⁵ C Black, "Taxing Crime: the application of Income Tax to illegal activities" (2005) 20(3) *Australian Tax Forum* 435 at p 457.

⁸⁶ ITA 2007, section CA 1.

⁸⁷ Section DA 1 of the ITA 07 is known as "General Permission".

⁸⁸ *Mangin v CIR* [1971] NZLR 591 PC and *CIR v Alcan NZ Ltd* (1994) 16 NZTC 11,175.

the general permission, decides whether a deduction is allowed for the expenditure or loss.⁸⁹

In considering the taxation of the illegal profits there remains a punitive element in the reasoning adopted. While arguing that a taxpayer cannot set up his or her criminality as a reason to escape taxation the courts have not been so evenhanded in dealing with the deductibility of the career criminal's expenses, such as court fines and associated court costs. In this context court costs represent the contributions the convicted criminal is ordered to make to the other party's legal costs and should not be confused with the convicted party's own legal fees.⁹⁰ It is trite law to say that fines and court costs, generally, are not deductible by the party paying them.⁹¹ The basis upon which this is so has been discussed in this article.

It appears that, in the case of fines arising in circumstances that would suggest prima facie deductibility of those fines; a gloss has been put on the words of the section to deny deductibility. In Australia and New Zealand three potential reasons for this prohibition have been advanced: that the illegality severs the conduct from the business; that there are public policies reasons to prevent deductibility; and that those costs are private expenditure. Each of these reasons will be examined and, it is submitted, shown not to be apposite to the circumstances of illicit incomes.

A Illegality Severs Deductibility

This is the oldest of the reasons given for non-deductibility. As has been recognised by the High Court, the early cases discussed this point on the basis that the illegality which resulted in the imposition of a fine severs that particular expense from any business activity.⁹² In essence, this approach argues that there is a distinction between a cost arising from the expenses of a business (i.e.: the day to day expenses of being in business) and the costs of the conduct of the business. In *Robinson v CIR* the taxpayer claimed a deduction from assessable income a fine imposed by the Disciplinary Committee and a fine imposed by a Court. In the words of Tompkins J:

It is clear in my opinion that fines and penalties levied on a taxpayer by the Courts for breaches by

⁸⁹ But the courts in the United Kingdom and derivative jurisdictions kept them out using "quasi-personal" rationales which were eventually abandoned for all expenses apart from fines. Courts in other places such as the United States and Canada retained a small narrower carve out from the general deductions principle and based it on public policy grounds.

⁹⁰ *Robinson v CIR* [1965] NZLR 246, Tompkins J found that a fine imposed for negligent act of a practitioner was quite different from payment of damages suffered by a client. The nature of the penalty severed it from the expenses of trading. The fine was a penalty imposed as a personal deterrent and punishment. A taxpayer's own legal costs will be deductible provided these relate to the income earning process with a sufficient degree of nexus: for example *A v CIR* (1985) 7 NZTC 5,074. In that case the legal expenses of appearing before the Medical Council to avoid suspension from practice were allowed as deductible. The expenditure enabled the taxpayer to earn his income without interruption.

⁹¹ The Canadian courts went further and said even fines are deductible if they're not for serious offences.

⁹² *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213 per Sinclair J. In *Nicholas Nathan* case the taxpayer carried on a business of importing goods into New Zealand. The taxpayer imported goods in excess of its licence and was fined. The taxpayer sought to deduct fines, the cost of the forfeited goods, and the legal costs associated with the proceedings. Sinclair J held that the fines imposed were not deductible on the grounds of public policy. Legal costs incurred to obtain advice as to best way to minimise the penalties and losses which would flow through such infringement were held by the judge to be deductible. For examples of this approach see *Commissioner of Inland Revenue v Alexander Van Glehn & Co. Ltd* [1920] 2 KB 553 at 566; *Herald & Weekly Times Ltd v FCT* (1932) 48 CLR 113 and *Robinson v CIR* [1965] NZLR 246.

him of the law are not deductible by him. It is inflicted on the offender as a penal liability; it is a fine imposed on the offender for professional misconduct; it is inflicted on the offender as a personal deterrent and a punishment.⁹³

The judge concluded that a fine imposed for the negligent act of a practitioner was quite different from the payment of damages suffered by a client. The judge stated that in the case of damages there was a direct nexus to the income earning activity of the taxpayer.

The approach attempts to distance fines from other expenses on a quasi capital-revenue basis: that somehow a fine arises from the income earning structure rather than the income earning process.

There appears to be no basis for any attempt to treat a fine as being a capital expense if it arises from the day to day activity of the taxpayer in business. However, the conduct of business would not appear to sit easily with the approach that matters of capital relate to the business structure. The conduct of business would seem analogous to the idea of the process of business, making such costs deductible provided the nexus between the income earning process and the expense is sufficiently strong.⁹⁴ The artificiality of the "illegality severs deductibility" approach has been recognised by New Zealand High Court when it was stated that there is difficulty "in ascertaining just how the illegality, of itself, severs the connection between the business and the expense".⁹⁵

This artificiality is highlighted in the case of profits derived in their entirety from illegal activities. If it is the illegal nature of the activity that determines the deductibility of fines it follows that any expenditure incurred in pursuing the same illegal course must be tainted by the illegality and therefore non-deductible. This results in no permissible deductions whatsoever and consequently in tax being levied on the gross proceeds of criminal enterprises. Given that the tax system is intended not to advantage either the legitimate or illicit taxpayer, it cannot be correct to sever the nexus of deductibility on the basis of the legality or otherwise of the economic activity entered into. This issue was raised in the Australian case of *Commissioner of Taxation v La Rosa*.⁹⁶ The Administrative Appeals Tribunal held that, though the forfeiture by a drug dealer of personal property, real property and money valued at \$264,610 under the *Proceeds of Crimes Act 1987* was akin to a penalty, the statutory provision relating to penalties did not technically apply in these circumstances⁹⁷ but rather, that the connection between the forfeiture and the carrying on of the income producing activity had been severed and therefore the loss did not meet the test of the ordinary deduction provision.⁹⁸ This issue was not dealt with at Federal Court. The Administrative Appeals Tribunal (AAT) in *La Rosa* allowed deduction for monies stolen regardless of the illegality of the underlying activities.⁹⁹ The funds were lost

⁹³ *Robinson v CIR* [1965] NZLR 246 at p 249.

⁹⁴ *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 at p 360.

⁹⁵ *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213.

⁹⁶ *Commissioner of Taxation v La Rosa* (2000) AATA 625.

⁹⁷ Section 26.5 of the Income Tax Assessment Act 1997 (Cth), (Income Tax Assessment Act 1936 (ITAA 1936) s 51(4)) which denies a deduction for penalties was considered to require that the amount be paid by person whereas forfeiture was not an act of paying an amount: *Commissioner of Taxation v La Rosa* (2000) AATA 625. In *CIR v La Rosa* [2002] FCA 1036 the counsel for the Commissioner agreed that the loss in the case *La Rosa* was not of the same character as a fine; that is, it is not a punishment or personal deterrent.

⁹⁸ *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 at p 360.

⁹⁹ *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner Of Taxation* (1956) 95 CLR 344 was applied. In that case the day's taking were stolen as they were being carried to bank for deposit. In

during operations to acquire trading stock. The loss in *La Rosa* was the theft of assessable income. This position was confirmed by the Federal Court and Full Federal Court of Australia.¹⁰⁰

It is perhaps this lingering doubt as to exactly how the illegality prevented the deductibility of fines that resulted in an alternative basis for the non-deductibility of fines. Fines are imposed on persons for engaging in unlawful conduct, separate from taxpayer's income earning activities. Fines are not incurred in the course of deriving income because they are levied after income is earned; therefore deduction is not permitted as per section 8-1 ITAA97 and s DA 1 of the ITA07. It can be said that the recurrent penalties for parking infringements incurred by a courier driver or the fines imposed for engaging in unlawful activities such bookmaking or drug dealing for the purpose of earning assessable income are not treated as the business expenses, therefore not deductible.¹⁰¹

B Public Policy Reasons

It has become more common for the deduction of fines to be denied on public policy reasons. It is these public policy reasons that add a statutory consideration, outside of the necessary nexus to the income earning process, to determining deductibility. Public policy is a nebulous concept but expresses an inarticulate concept of society's norms of accepted behaviour underpinning the law, or as one commentator has characterised it "the unconscious result of instinctive preferences and inarticulate convictions".¹⁰²

The impetus for this approach is to simply say that fines are to punish illegal behaviour and that role would be diluted should such fines be treated as deductible. The US Supreme Court in *Tank Truck Rentals, Inc. v. Commissioner*¹⁰³ held that fines are not deductible as the frustration of the state policy would be severe and direct. If deductions were allowed they would reduce the sting of the penalty and thereby would have helped the taxpayer avoid the consequences of the violation. With this approach it does not matter what the nexus to income earning is; fines are imposed to discourage illegal conduct and it would go against public policy to allow a partial recovery of the penalty through the tax system.¹⁰⁴

By this reasoning any fine is non-deductible regardless of circumstance. Yet there

Australia in response to the *La Rosa* case, s 26-54 ITAA 97 was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence.

¹⁰⁰ *Federal Commissioner of Taxation v La Rosa* [2003] 53 ATR 1. L Siska, "Deductions arising from illegal activities", (2003) 13 *Revenue Law Journal* 115, at p127: 'By interpreting the tax statute as an instrument simply to collect appropriate taxes, the Federal Court in *La Rosa* brought the law of deductibility of such losses properly into line with the case law defining assessable income.'

¹⁰¹ Taxation Review Authority No 105/05; Decision No 9/2008 at par 109.

¹⁰² OW Holmes, "Puritanism and the Law", in M.De Wolfe Howe (ed), *The Common Law*, Cambridge, Mass, Harvard University Press, 1968, at p 31-32.

¹⁰³ *Tank Truck Rentals, Inc. v. Commissioner* [1958] 356 US 30.

¹⁰⁴ *Mayne Nickless Ltd v FCT* (1984) 84 ATC 4,458 at 4,470 and *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213. In *Nicholas Nathan Ltd* the taxpayer was fined for importing goods in excess of its licence. The fines imposed were held by Sinclair J not to be deductible on the grounds of public policy. The legal costs associated with the proceedings were held by the judge to be deductible. It was commercially prudent to take legal advice as to whether in fact there had been a breach of law. Had the taxpayer taken legal advice before importing goods, the judge had no doubt that the costs incurred in taking that advice would have been allowed as deductible expense.

remains the problem of continued dicta to the effect that recurrent regulatory offences, such as parking offences, can be deducted provided there was sufficient nexus to the earning of income or to the conduct of business.¹⁰⁵ In other words depending upon the nature of the offence some members of the judiciary would forego the public policy issue and allow deductibility on ordinary taxation principles. With respect, this would offer a more reliable measure of deductibility than references to public policy. In *Magna Alloys & Research Ltd v FCT*¹⁰⁶ legal costs of defending criminal charges brought against company's directors alleging that its selling methods resulted in the payment of secret commissions were allowed as fully deductible. The basis of that finding was that the provision of the legal assistance to the directors and agents of the company also assisted in protecting the company's marketing methods and the goodwill and reputation of the company.

Further there is the issue of competing public policy issues. Each statute presumably represents some public policy concern. As this discussion shows these are not always consistent. The public policy of gaining revenue from net income rather than gross is contrasted with the public policy of punishing offences. Then the offences need to be ranked. The Courts suggest that at least traffic offences are less important than the public policy underpinning revenue legislation. Another variation on this issue is identifying whose public policy is to be preferred.¹⁰⁷ If there is to be a "ranking" of the importance of those public policies, perhaps it should be done by the legislature.¹⁰⁸

Thus it seems that a blanket application of the perceived public policy is not possible, as there is no commonly accepted position for such minor regulatory infringements, even within the body that administers those laws. One of the difficulties in citing a public policy reason remains that public policy is based upon society's norms of behaviour and these are not only fluid in time but also across society itself.

The weakness of the public policy argument is highlighted, once again, when considered in the case of a completely illicit income. Again if the public policy against deductibility of fines is correct, then any expense incurred in the earning of illegal income should be treated as analogous to a fine and therefore not deductible by reason of public policy. However, if expenses are inherent to earning income e.g. purchase of trading stock, they are deductible. It is submitted that it is no answer that a fine is imposed from outside (i.e. through the process of law) as public policy; the discouragement of crime, is equally applicable to any expense incurred in the earning of illegal income.

¹⁰⁵ *Day & Ross Ltd v R* [1976] CTC 707 where a transport firm was able to deduct traffic infringement notices and *Case K62* (1988) NZTC 504 where a mail courier company was able to deduct a double parking infringement notice while delivering an urgent package to a downtown office.

¹⁰⁶ *Magna Alloys & Research Ltd v FCT* (1980) 80 ATC 4,542 at p 4,546.

¹⁰⁷ *Cattermole v Borax & Chemical Ltd* (1949) 51 TC 202 the taxpayer was denied a deduction in Britain for fines arising from trading in the United States (breaching anti trust laws); even though the trading was not illegal in Britain.

¹⁰⁸ R Kreyer, "The deductibility of fines. Considerations from law and policy perspectives" (1984) 13 *Australian Tax Review* 168. Kreyer argued for legislative intervention to resolve the issue; in the same year, 1984, s 51(4) was enacted into the Federal Tax Acts to prohibit the deduction of any penalty imposed. Also see discussion in R Hamilton, "The deductibility of fines, penalties and legal expenses" (1980) 13 *Australian Tax Review* 168 and K Day, "The tax consequences of illegal trading transactions" [1971] *British Tax Review* 104.

The treatment of so-called “quasi-personal expenses”¹⁰⁹ was considered in *La Rosa*¹¹⁰ and it was concluded that such analysis was misplaced in the context of the theft loss at issue in the case. The court noted that at the time of loss, the taxpayer’s cash had been earmarked for use in connection with the acquisition of drugs as trading stock. That is, the fact that the underlying activity is illegal does not taint the otherwise ‘ordinary’ expense incurred. Truly tainted outgoings such as bribes are denied deductibility under provisions inserted by the New Zealand and Australian legislature¹¹¹ as a matter of public policy. Other outgoings must be analysed to determine whether they are incurred in carrying on the business or income generating activity regardless of whether that activity is legal or illegal. In the special leave to appeal *La Rosa* case to the High Court, the Australian government argued that a public policy doctrine was established by the courts prior to the introduction of s 51(4)¹¹² of the Income Tax Assessment Act 1936 (Cth) and that it continues to live on – this view forming the basis of the argument that the deductions should have been denied in the *La Rosa* case.¹¹³

While perhaps a more intellectually honest reason for denying deductibility, the reliance on public policy does not provide a reliable basis for denying deductibility of fines incurred in the earning of or in the course of business to earn assessable income. However, it is possible that an application of the ordinary test of deductibility might provide a single coherent basis.

C Fines as Private Expenditure

The third approach to denying the deductibility of fines is to account them to be private or personal expenditure. The genus of this approach is in statements in the early cases that it is the conduct that is being punished.¹¹⁴ While one line of reasoning concluded that the illegality of that conduct meant the fines incurred were not deductible, another approach is to consider that conduct being punished as private or personal conduct and for that reason the fines incurred are not deductible.¹¹⁵

This approach does not favour any reliance on perceived public policy or on the illegality being punished in favour of the illegal activity being something personal to the lawbreaker and therefore not to be considered part of the business of income earning at all. By such an approach any other expenses incurred in the course of an illegal business would be deductible provided these meet the necessary nexus of expenditure to income or business. It is only fines that are attributable to personal conduct and thus unable to be deducted. This approach relies on the form of the

¹⁰⁹ See R Krever, “The deductibility of fines. Considerations from law and policy perspectives” (1984) 13 Australian Tax Review 168 for a detailed discussion of development of the quasi –personal expenses doctrine in Australia.

¹¹⁰ CIR v *La Rosa* (2003) 53 ATR 1.

¹¹¹ ITA 2007, s DB 45; s 26-52 and s 26-53 ITAA 97. Section 26-52 and s 26-53 ITAA 97 were enacted for 1999-2000 and subsequent years.

¹¹² Income Tax Assessment Act 1936, s 51(4); also see equivalent section in Income Tax Assessment Act 1997 s 26.5. Section 26-5 provides that a taxpayer is not entitled to deduct: an amount (however described) payable by way of penalty, under an Australian law or ‘foreign law’, or an amount ordered by the court to be paid on conviction of an entity for an offence against Australian law or foreign law.

¹¹³ Commissioner of Taxation v *La Rosa* [2004] HCA Trans 420 (27 October 2004).

¹¹⁴ *Herald & Times Weekly Ltd v FCT* (1932) 48 CLR 113 at 120 it was said: “The penalty is imposed as a punishment of the offender ... Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it not incurred by him in his character of trader”.

¹¹⁵ Case K62 (1988) NZTC 504 per Barber J and Case L15 (1989) 11 NZTC 1,113.

normal test of deductibility but it is questionable that the substance is being applied.

The difficulty is that some cases accept that the imposition of fines can arise from the conduct of business but deny deductibility for other reasons, as outlined above. Other cases, in dicta, accept that, in an appropriate case, minor infringements would be deductible.¹¹⁶ This seems to belie the approach that fines are personal behaviour punishments and thus not deductible.

Finally it is submitted that some forms of law breaking are so intimately connected to the business of earning income that it is impossible to deny deductibility on the basis of a lack of the necessary nexus. That appears to be the view considered in the dicta relating to *traffic* fines and, in my submission, is equally applicable where the illegal behaviour being punished is directly responsible for the income that is being taxed, for example bookmaking or drug dealing. The illegality is not peripheral to the income earning process (such as with traffic offences); it is central to that process, making the treatment of fines as personal expenses somewhat difficult to accept as anything but a legal fiction.

D New Zealand Inland Revenue Approach

Not surprisingly, the uncertainty regarding the deductibility of fines and similar penalties finds itself repeated in the Commissioner's approach to the issue. The Commissioner issued a draft Interpretation Statement to examine the income tax deductibility of fines, penalties and like payments. In approaching the deductibility of fines and penalties the statement seeks to develop consistent and cohesive conceptual framework based on the existing Commonwealth jurisdiction authorities. In the Draft Interpretative statement,¹¹⁷ the Commissioner identifies three factors to be considered when determining deductibility of fines and penalties. These are; whether it is incidental to deriving gross income; whether the taxpayer could have reasonably be expected to run his business in consistent conformity to the law; and whether there is a public policy reason to deny deductibility. In the second factor (whether the taxpayer could have reasonably be expected to run his business) in consistent conformity to the law the Commissioner is telling the taxpayer how to run his business. The last item appears to require the Commissioner's officers to determine and balance the completing public policy issues that have concerned the courts and there is no reason to believe they will find this element any easier than the courts.

Further, the policy statement requires a determination of the appropriate method by which the taxpayer should conduct his or her business activities: could the taxpayer reasonably run his business in conformity with the law. An immediate inconsistency would appear to arise in the application of this test. Whereas a completely illegal business can not be run in conformity with the law (and therefore, presumably, any fines would be deductible) if a legitimate business breaches a law and it could be said that the business could have been run in conformity with the law and then fines not deductible. Further this test would appear to substitute the Commissioner's view of the appropriate way to conduct the taxpayer's business for that of the taxpayer – an approach the courts have rejected in the past.¹¹⁸ Finally it is doubtful this test adds anything to the statutory test of the expense being "necessarily incurred by the

¹¹⁶ *Cattermole v Borax & Chemical Ltd* (1949) 51 TC 202: the taxpayer was denied a deduction in Britain for fines arising from trading in the United States (breaching anti-trust laws), even though the trading was not illegal in Britain.

¹¹⁷ New Zealand Inland Revenue IS 0006[d] issued January 1998.

¹¹⁸ *Grieve v CIR* (1984) 6 NZTC 61,682 and *Cecil Bros. Ltd v FCT* (1964) 111 CLR 430.

taxpayer in the course of carrying on a business...."¹¹⁹ The draft Interpretation Statement concluded that in certain situations a deduction might be available for fines and penalties. Upon further consideration the Commissioner thought that such an approach did not reflect current law and issued a revised¹²⁰ draft Interpretation Statement. The revised draft Interpretation Statement concluded that irrespective of whether the statutory nexus is met, fine and penalties are not deductible in New Zealand because of the application of public policy considerations. However, the revised draft Interpretation Statement could not determine the correct tests that should apply in the New Zealand context therefore, it had not been finalised and issued.

E Deductibility of Fines and s DA 1 of ITA 07 and s 8-1 of ITAA 97

In *Nicholas Nathan Ltd v CIR* it was suggested by Sinclair J that the non-deductibility of fines is:

somewhat analogous to the taxation imposed upon gains derived from illicit or illegal operations with the result that there is no discrimination in favour of lawbreaking taxpayers.¹²¹

His Honour concluded his comments with the oft-heard phrase that there is no equity in tax.

However, as has been discussed above, the treatment of fines is not analogous to the treatment of the income from illegal activity. The courts stress that illegal incomes are taxable in the same way as legitimately derived income, regardless of moral considerations. While considering the deductibility of the hazards of such behaviour sometimes the courts are reluctant to consider applying the same tests of deductibility that are applicable to "legitimate" expenses. If such tests are shorn of the illegality influence and the public policy considerations, we are left with the normal test of deductibility (at least in form, if not application).

While it can be accepted there is no equity in tax, it is submitted that such tests that are applicable to taxation, should be applied evenhandedly. When considering the issue of deduction of fines or other expenses for legal or illegal activities as per s DA 1 of ITA 07 and section 8-1 of ITAA97 deductions should be allowed for all expenses incurred in the course of deriving assessable income, leading to a determinate result.

VI CONCLUSION

The scope of illegal profits is significant to the New Zealand and Australia tax base. Therefore, it is necessary to develop a unified approach to taxation of this income. While the ordinary concepts of taxation are capable of being applied to determine taxability it is clear that these have not been applied by the legislation in a consistent manner.

In the case of a gain to a criminal, in New Zealand from 1 April 1995, legislation is being put into place to override the impact of equity on the passing of property in determining whether the taxpayer made a taxable gain. Without this legislation the ordinary tests of assessability would be applicable and where the criminal failed to obtain the beneficial ownership of the money received, there is no income to the

¹¹⁹ ITA 07, s DA 1; Section 8-1 ITAA 97.

¹²⁰ New Zealand Inland Revenue Department (IRD) IS 0006[d 2] issued October 1999.

¹²¹ *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213 at B23.

criminal. The New Zealand Court of Appeal has unequivocally rejected the doctrine of claim of right (regardless of inconsistencies this creates within the Act). Now, however, such legislation would disregard the application of the ordinary principles by legislating, for the taxability of such sums. This would appear to be based upon policy arguments in favour for taxability. However, the existence of constructive trust has prevented the taxation of the amounts as income of the embezzler in Australia.

The courts and the Commissioner in Australia and New Zealand have relied upon a number of arguments to deny deductibility of expenses that would otherwise appear to meet the statutory test¹²² of deductibility. Broadly these reasons are that illegality severs deductibility on quasi-capital basis, public policy grounds, and treating expenses as private expenditure. Upon examination of each of the purported bases for disallowing such deductions, the overwhelming conclusion is that there is no particular reason for denying deductibility of such expenses. None of these arguments are particularly convincing – even in the courts themselves there are numerous dicta indicating some forms of fines are potentially deductible. It is submitted that this prohibition (both in terms of ordinary and illicit business activity) appears to have no justification other than judicial repugnance to allowing such a deduction.

In 1982, on public policy grounds the United States Internal Revenue Code¹²³ was amended to deny deductions for expenses incurred in carrying on a trade or business of drug trafficking and there appears to be no similar provision directed at other serious crimes.

In Australia in response to the *La Rosa* case¹²⁴, s 26-54 ITAA 97¹²⁵ was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence¹²⁶. The new provision applies to amounts incurred after 29 April 2005. It seems to indicate that the punishment of those engaged in unlawful activities is not only imposed by criminal law, but also by the income tax provisions. The amendment to Australian ITAA was made under political pressure¹²⁷ and had been seen to raise several tax principle¹²⁸ issues. The author thinks that it was deliberately

¹²² ITA 2007, s DA 1; s 8-1 ITAA 97.

¹²³ Internal Revenue Code (IRC) s 280E provides: “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedules I and II of the Controlled substances Act) which is prohibited by Federal Law or the Law of any State in which such trade or business is conducted”.

¹²⁴ *CIR v La Rosa* (2003) 53 ATR 1.

¹²⁵ Section 26-54 Income Tax Assessment Act 1997 (ITAA 97) provides: “You Cannot deduct under this Act a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment”.

¹²⁶ Tax laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005 (Cth), Explanatory Memorandum at [6.8] interprets “on indictment” as meaning an offence punishable by imprisonment for 12 months or more. This appears to be position under federal law ; it may vary from state to state.

¹²⁷ The day after the decision of the Federal Court, numerous articles appeared in Australian newspapers and topic was discussed extensively on radio. For example, “Drug dealer to get tax breaks”, *The Age* (Melbourne), 22 August; “Illegal loot still income, but very few may claim”, *Sydney Morning Herald* (Sydney), 23 August 2002.

¹²⁸ Section 8-1 ITAA 97 provides that taxpayers are allowed to claim deductions for expenses incurred in gaining or producing their assessable income e.g. If the money is stolen when the manager drives up to the bank to drop it in the deposit slot, there is an offsetting deduction.

drafted narrowly and it is doubted would the amendments have any application if the facts in *La Rosa* were to occur today would the amendment amount to an additional penalty with respect to the illegal activity and be able to stop the deduction of expenses he incurred in that case. The section 26-54 ITAA 97 applies to expenses incurred in the course of illegal activity.¹²⁹ The loss in *La Rosa* was the theft of assessable income; the funds were lost during operations to acquire trading stock.

The Literature review shows that New Zealand legislature has two options: to incorporate a provision similar to United States Internal Revenue Code Section 280E or to incorporate a provision similar to s 26-54 ITAA 97. In the United States, an adjustment for the cost of goods sold is made to the gross proceeds in determining the gross income from the transactions. From gross income then deductions are allowed for expenses and losses such as wages and rent. However, this provision has no affect on the adjustment to gross receipts with respect to effective cost of goods sold. In contrast, in New Zealand, the gross proceeds are treated as ordinary income (s BC 2 ITA 2007), the cost of trading stock is allowed as ordinary deduction (s DA 1 ITA 2007). Therefore, incorporating a no deduction provision similar to that in the United States would mean that those who deal in illegal goods will be assessed on gross proceeds without an adjustment for cost. This would obviously lead to tax policy issues. Incorporating a provision similar to the Australian no-deduction provision for expenses incurred in the course of carrying out of an indictable offence is also not a particularly appealing choice to deter people from engaging in such activities. Philip commented that s 26-54 ITAA 97 should be repealed.¹³⁰ Taxation law should be applied neutrally and equally and not as a punitive measure. Therefore, to justify the adoption of a no deduction provision, strong policy reasons would have to be provided by the legislature for violating the principles of neutrality and equality in the eyes of taxation law.¹³¹ It is further submitted that in the absence of a clear statutory prohibition of deductibility, and to provide increased certainty to all taxpayers, a more transparent approach would be achieved by simply applying statutory test¹³² of deductibility for all expenses incurred in the course of deriving assessable income and putting no gloss on the words of the section to deny deductibility.

However, if New Zealand Parliament decides to adopt no deduction provision the legislature could specify the activities which it considers warrant this treatment; e.g. indictable offence or similar to the treatment of bribes paid to public officials.¹³³ Another important issue which this article does not consider is whether it will be appropriate to use income tax as a potential weapon to deter income generating crimes. Future research should examine the effectiveness of such a tax penalty to deter crime and policy reasons for violating the principles of neutrality and equality.

¹²⁹ Section 26-54 ITAA 97 preserves the deductibility of expenses which are not illegal in themselves to the extent they are not directly used for illegal purpose. This is not easy to apply in practice. For example, the owner of a bar is prosecuted trading after hours. Is he denied deductions for all or part of his expenses (incurred after hours)? What is the basis for allocation of rent, power, depreciation, telephone rental, rates etc?

¹³⁰ P Burgess, "Deductions and illegal Income" (2008) 34(1) Australian Tax Review 7 at p 13: "in writer's view, it would be simpler to repeal s 26-54 of ITAA 97.

¹³¹ S Lund, "Deductions Arising from Illegal Activities" (2003) 13 Revenue Law Journal 115.

¹³² ITA 2007, s DA 1; ITAA 97, s 8-1.

¹³³ ITA 2007, s DB 45; ITTA 97, s 26-52 and s 26-53.

THE INFLUENCE OF TAX REFORM ON ENTREPRENEURSHIP AND MANAGEMENT PRACTICES IN THE SMALL BUSINESS SECTOR IN AUSTRALIA

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Extensive tax reform has been ongoing in Australia since 1985 and many of these reforms have had major impact on the reporting requirements for small businesses. The vast majority of businesses in Australia are small businesses and they are a major source of employment and economic activity. Less regulation and a more sound understanding of small businesses could allow owners to give greater attention to being entrepreneurial, to better manage their cash and other liquid assets, and to implement more effective management practices. Communication, a shared vision, and a commitment to clear, consistent and integrated policies by governments are needed.

I INTRODUCTION

This paper provides a review of the effect of tax reform on entrepreneurship and management practices in the small business sector in Australia and identifies areas where policymakers and governments could provide further support to the sector. Small businesses play a major role in Australia because of the level of employment that they generate and their contribution to the economy. Since 1985 there has been continual and extensive reform of the Australian taxation system. Many of these reforms have directly, and quite profoundly, affected the way small businesses operate and manage their resources. In particular, tax reforms introduced in 2005 were specifically targeted at supporting entrepreneurship.

The entrepreneur has been defined as someone who specialises in making judgmental decisions about the coordination of scarce resources.¹ J. B. Say,² one of the first writers on entrepreneurship, described an entrepreneur as the person who both owned and ran the business. Timmons³ defined entrepreneurship as a human creative act involved in finding personal energy by initiating and building an enterprise or organisation, rather than by just watching, analysing or describing one. Other authors have emphasised the role of creativity and innovation as an intrinsic part of the entrepreneurial process.⁴ Many policy questions are centred about entrepreneurship including those related to science and technology, sustainability, poverty, human capital, endogenous resources, employment, and taxation. Further, research priorities to date have focused on understanding and creating environments supportive of

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¹ See for example Casson, M, *The Entrepreneur: An Economic Theory* (2nd edn 2003).

² Cited in Drucker, P F, *Innovation and Entrepreneurship* (1985) 19.

³ Timmons, J A, *New Venture Creation: Entrepreneurship for the 21st Century* (4th edn 1994).

⁴ For example see Schumpeter, J A, *The Theory of Economic Development* (1934); Acs, Z, Desai, S and Klapper, L, 'What does 'entrepreneurship' data really show?' (2008) 32 *Small Business Economics* 264.

entrepreneurship in recognition of its potential to drive more positive outcomes on many of these policy issues.⁵

For tax purposes the concept of an entrepreneur is considerably narrower and is defined according to annual turnover (as being below \$75,000) and is unrelated to business structure.⁶ The persistent tension between tax reform and the small business sector has been the subject of considerable debate and research both in Australia and overseas,⁷ and in particular, the extent to which tax reforms have stifled entrepreneurship and imposed inefficient management practices, including regressive compliance costs, on small businesses.⁸

There are six parts to this paper with the introduction being part one. Part II provides an explanation of the evolving definition of 'small business' in Australia and provides the background for the analysis that follows. This is followed by part III which is an overview of the tax reforms themselves with particular emphasis on those reforms from 1999 onwards that directly impact on small businesses. Part IV includes a chronological narrative discussion of various key research studies that have been conducted onto the impact of tax reform on small businesses in Australia. The paper then brings together the preceding parts and an analysis of the current state of play is presented in part V. The final part draws conclusions, makes recommendations for future policy and identifies areas where further research is needed.

By way of background, the Australian Bureau of Statistics has defined a 'small business' as one that employs less than 20 people for reporting purposes.⁹ On this basis, as at June 2004 it was estimated that there were 1.269 million small businesses operating in Australia, the majority of which had been in operation between 1 and 5 years (33 per cent) and were run by sole operators (72 per cent). In 2007 it was reported that there were around 1.84 million small businesses in Australia representing around 93 per cent of all businesses, and providing around 39 per cent of Australia's value added and employing almost half of the non-agricultural workforce.¹⁰ Small businesses in Australia account for approximately 35 per cent of national economic activity.¹¹

However, the Australian Taxation Office (ATO), for administrative and management purposes, categorises businesses based on turnover. On this basis, there

⁵ Acs *et al* n 4.

⁶ See s 61-505 *Income Tax Assessment Act 1997*.

⁷ For example, see Abdul-Jabbar, H and Pope, J, 'The Effects of the Self-Assessment System on the Tax Compliance Costs of Small and Medium Enterprises in Malaysia' (2008) 23 *Australian Tax Forum* 289; DeLuca, D, Stilmar, S, Guyton, J, Lee, W L and O'Hare, J, 'Aggregate Estimates of Small Business Taxpayer Compliance Burden' (2007) *IRS Research Bulletin* 163; Blazic, H, 'Personal Income Tax Compliance Costs at an Individual Level in Croatia' (2004) *Australian Tax Forum* 325; Hasseldine, J and Hansford, A, 'The Compliance Burden of VAT: Further Evidence from the UK' (2002) *Australian Tax Forum* 369; and Ritchie, K, 'The Tax Compliance Costs of Small Business in New Zealand' in Evans, C, Pope, J and Hasseldine, J, (2001) *Tax Compliance Costs: A Festschrift for Cedric Sandford*, 297.

⁸ Chittenden, F, Kauser S and Poutziouris, P, 'Tax Regulation and Small Business in USA, UK, Australia and New Zealand' (2003) *International Small Business Journal* 93; Coleman, C and Evans, C, 'Tax Compliance Issues for Small Business in Australia', (2003) in Warren, N (Ed.) *Taxing Small Business – Developing Good Tax Policies* 147; and Chittenden, F and Sloan, B, 'Taxation and Public Policy Towards Small Firms: A Review' (2007) *Australian Tax Forum* 31; and Pizzacalla, M, 'Australia's SME tax identity crisis' (2007) *Australian Tax Forum* 19.

⁹ Australian Bureau of Statistics, 8127.0 'Characteristics of Small Business Australia' (2004).

¹⁰ The Board of Taxation, 'Scoping Study of Small Business Tax Compliance Costs: A Report to the Treasurer' (2007). The Report was released by the Treasurer on 12 November 2008.

¹¹ Australian Bureau of Statistics, 8155.0 'Australian Industry 2003-04' (2006).

are around 1.9 million individuals and 600,000 companies operating as 'micro' businesses in Australia with an annual turnover below \$2M. These micro businesses collectively employ 25 per cent of Australia's workforce and pay about 11 per cent of the total taxes collected by the ATO.¹²

In spite of the variations apparent in the approach taken by government departments in describing small businesses, it is clear that in terms of economic contribution, revenue collections and employment, the small business sector (in its broader sense) plays a vital role in Australia. It follows that the sector could potentially have considerable influence on government, particularly in relation to obtaining concessions and incentives. However, the small business sector with its many diverse industry groups and lack of unity has tended not to realise its full potential as a lobby group compared to larger corporations (with peak bodies such as, for example, the Business Council of Australia).

II DEFINING A SMALL BUSINESS FOR THE PURPOSES OF TAX LAW

Until 1 July 2007, there has been no single definition of a small business for tax law purposes in Australia. For example, s152-15 of the *Income Tax Assessment Act 1997* in respect of tax on capital gains defined a small business in terms of its net assets not exceeding \$5M. However, s960-335 of the same Act defined a 'small business taxpayer' as having an average annual turnover of less than \$1M. From a tax law perspective, the definition of a small business is important as it normally determines how a taxpayer is to be treated, how often it is required to report, the accounting system to be used, and whether or not any tax concessions apply. For example, a small business with an annual turnover of less than \$1M could account for Goods and Services Tax (GST) on a cash basis instead of an accrual basis and pay its quarterly tax instalments on the basis of GDP-adjusted notional tax.¹³ Further, there are exemptions on capital gains tax for eligible small businesses when owners retire or rollover capital gains made into the acquisition of another business.¹⁴

The lack of alignment of the definition of a small business for tax law purposes was one aspect of concern raised by the Banks Taskforce¹⁵ in its report to the federal government on how to reduce the regulatory burden for Australian businesses. In response, changes were introduced to simplify the alignment of the various small business relief arrangements contained in the tax laws.¹⁶ From 1 July 2007 there is a common definition used for access to most small business concessions, namely the \$2 million annual turnover,¹⁷ and the former Simplified Tax System (STS) was effectively abolished.¹⁸ While these changes were positive, it remains to be seen as to how widely (in terms of other federal departments and at the level of state government) the single tax definition of a small business will be adopted. However, while unaligned definitions for the purposes of tax law are problematic, there are

¹² Australian Taxation Office, *2007-08 Compliance Plan* (2008).

¹³ Australian Taxation Office, 'Activity Statement Essentials' (2008) available at <http://www.ato.gov.au>. Also s 29-40 *A New Tax System (Goods and Services Tax) Act 1999*.

¹⁴ See Div 122, *Income Tax Assessment Act 1997*.

¹⁵ Banks, G. *et al*, 'Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business' (2006).

¹⁶ Tax Laws Amendment (2006 Measures No. 7) Bill 2006 was first introduced to Parliament on 7 December 2006 and given assent on 12 April 2007, Act No. 55.

¹⁷ See s 328-110 *Income Tax Assessment Act 1997*.

¹⁸ For further discussion of the STS and its shortcomings see McKerchar, M, 'Is the Simplified Tax System Simple?' (2007) 10 *The Tax Specialist* 140.

arguably other more significant tax issues that impact on small businesses and are consequences of the rapid and extensive tax reform that has been experienced in Australia.

Income tax makes up the largest component of the Australian federal government's revenue base.¹⁹ The States and Territories raise a range of other taxes including payroll tax, stamp duties and land tax, with each having its own taxes, legislation and reporting requirements. Local governments (of which there are over 700 in Australia) principally rely on land rates and direct grants from their respective state governments.²⁰ Governments at these various levels operate under a range of administrative structures that largely function in an independent manner (or at least appear to lack any co-ordination or inter communication) which has compliance cost implications for small businesses. This is in addition to the regressive compliance burden imposed on small businesses by taxation. This particular phenomenon is apparent worldwide and, in spite of attempts to address it by many governments, there appears to be little evidence of progress being made.²¹

III TAX REFORM

In terms of tax reform, few countries have experienced the rate of reform as has Australia, particularly since 2000, though it has been taking place almost unabated for more than 20 years. In the mid 1980s major administrative and technical reforms included the introduction of self assessment for all taxpayers and the introduction of a number of new regimes including Capital Gains Tax (CGT),²² Fringe Benefits Tax (FBT)²³ and dividend imputation.²⁴

With the introduction of self assessment the burden of assessing annual tax returns shifted from the ATO to taxpayers thereby allowing the ATO to shift its resources to enforcement and other compliance related activities. Taxpayers sought greater certainty about their tax affairs and in response the ATO issued public and private rulings and governments passed more and more legislation. Apart from being voluminous, the legislation was widely regarded as extremely complex. In 1993 the Government announced that the tax legislation would be written in 'plain English' though this project was later abandoned²⁵ (only one third complete) once the decision was made to introduce major reforms including a GST (to replace the wholesale sales tax) and the ill-fated STS for small business (and other related reforms in a package referred to as "A New Tax System" or ANTS) from 1 July 2000. As a result, in addition to the *Income Tax Assessment Act 1936*, there is also the 'plain English'

¹⁹ Australian Taxation Office, *Taxation Statistics 2005–06* (2008).

²⁰ Koutsogeorgopoulou, V, 'Fiscal Relations Across Levels of Government in Australia', (2007) 541 OECD Economics Department Working Papers.

²¹ See n 7.

²² Introduced as Pt IIIA of the *Income Tax Assessment Act 1936*.

²³ See the *Fringe Benefits Tax Assessment Act 1986*.

²⁴ The imputation provisions were originally contained in Pt IIIAA of the *Income Tax Assessment Act 1936* and have been replaced by the provisions contained in Pt 3-6 *Income Tax Assessment Act 1997*.

²⁵ Woellner, R, Coleman, C, McKerchar, M, Walpole, M and Zetler, J, 'Can Simplified Legal Drafting Reduce the Psychological Costs of Tax Compliance?: An Australian Perspective', (2007) 6 *British Tax Review* 717.

Income Tax Assessment Act 1997, the outcome in fact being more legislation rather than less.²⁶

The introduction of GST from 1 July 2000 had enormous impact on small business practices. The GST applies at a flat rate of 10 per cent on the supply of most goods and services and is collected by the supplier who is required to be registered for GST purposes where the annual turnover exceeds \$75,000 (assuming it is not a non-profit business).²⁷ However, many smaller businesses chose to register in order to be able to claim input credits. Prior to the introduction of GST, there were some 79,000 businesses registered in Australia to collect Wholesale Sales Tax (WST) which the GST effectively replaced.²⁸ In terms of the efficiency of revenue collections, the WST was far superior compared to the GST which had 2.3 million businesses registered as at 2 July 2004.²⁹ Once registered, small businesses choose their accounting method for GST and this can be different to the method employed for income tax purposes. Many small businesses account for GST on a cash basis as this would generally have a positive impact on net cash flow and the reporting requirements are generally more manageable for the business owner.

Prior to the introduction of the GST many small businesses had cash flow problems and this was considered to be main cause of business failure.³⁰ Often this failure was due to lack of knowledge and/or poor planning on the part of small business owners who did not factor their tax obligations into the management of their cash flow and make adequate provisions to ensure liquidity. It was advocated that when a small business owner has a better understanding of their tax obligations and tax entitlements their cash flow can improve.³¹

As part of the introduction of GST, a single identifier, an Australian Business Number (ABN) was introduced. In business-to-business transactions, the ABN of the supplier must be quoted otherwise the customer is required to withhold tax at the rate of 48.5 per cent from the payment. The ABN is used in dealings with all government departments and with customers. Small businesses have had to improve their record keeping practices to cope with these legislative reforms. Further, there have been numerous administrative reforms as the ATO has continually enhanced its provision of electronic services and small businesses have had to adapt accordingly. The ATO has provided software to help businesses manage their records and electronic portals for lodging returns and accessing information. However, it does appear that small businesses are struggling to meet the required standard of record keeping with the ATO reporting that 30 per cent of micro businesses failed in this regard.³²

It can be argued that the need for regular reporting of activity by small businesses (as required under the GST system) should lead to improved efficiency and profitability as managers have access to more timely information on their performance. However, this may not necessarily make small businesses better at

²⁶ Note that while efforts have since been made to repeal inoperative provisions (leading to the repeal of more than 2,000 pages of legislation effective 14 September 2006), the continued existence of two Acts remains unaddressed.

²⁷ The annual turnover threshold increased from \$50,000 to \$75,000 from 1 July 2007. See *A New Tax System (Goods and Services Tax) Act 1999*.

²⁸ Warren, N, *Tax Facts Fiction and Reform* (2004).

²⁹ Australian Taxation Office, *Taxation Statistics 2003-04* (2006).

³⁰ Bickerdyke, I, Lattimore, R, and Madge, A, 'Business Failure and Change: An Australian Perspective' (2000) Productivity Commission.

³¹ Australian Taxation Office, 'Complete Tax Guide for Small Business' (2000).

³² Australian Taxation Office, 2005, 'Compliance Program 2005-06' (2005).

managing liquidity. For the financial year ended 30 June 2006 the ATO³³ reported that 67 per cent of the total tax debt outstanding was owed by micro businesses. It was expected that the extensive reporting required under the GST system would reduce opportunities for businesses to evade income tax. However, it is possible that the introduction of GST has increased the size of the cash economy rather than reduced it.³⁴

At the same time as introducing the GST, the STS for income tax purposes was introduced for small businesses. The STS initially required cash accounting and had different rules for calculating depreciation (including immediate write-offs for acquisitions costing less than \$1,000) and requirements for accounting for trading stock. Eligibility to use the STS was based on annual average turnover and the intention was that it would offer reduced compliance costs to small businesses. However, at the end of the 2002 financial year only 4 per cent of eligible small businesses had elected to be taxed under the STS.³⁵

In response to ongoing criticisms, further reforms were introduced effective from 1 July 2005. These include relaxing the mandatory use of cash accounting for income tax purposes and the introduction of a 25 per cent Entrepreneur's Tax Offset (ETO).³⁶ The ETO is limited to taxpayers with an annual turnover of less than \$75,000, with the full offset of 25 per cent applying only on turnovers of \$50,000 or less. The offset is, in effect, recognition of and direct compensation for the regressive nature of compliance costs.³⁷ However, in reality any compensation is limited to only very small businesses, or businesses that are in the 'start up' phase. It is not simple and it is difficult to see how it will help encourage entrepreneurship given the low threshold. Further, findings from studies into entrepreneurship have been inconclusive as to its drivers and impediments and this may be attributed to country-specific differences. The nature and direction of causal relationships between entrepreneurship and influences such as unemployment, poverty, and the regulatory burden of taxation are not yet clearly understood.³⁸

In contrast to the apparent merit in encouraging entrepreneurship, there are other reforms designed to protect the integrity of the tax system such as the non-commercial losses regime³⁹ and the personal services income regime⁴⁰ which seem to be at odds to this intent. The non-commercial losses regime basically denies an immediate deduction for a loss made by a small business where certain conditions are not satisfied (such as annual sales not exceeding \$20,000). That is, where the business has not yet reached a 'commercial' level – which in effect would commonly be the start-up phase. The personal services regime effectively stops small business owners who operate from home from being taxed under any business structure other than a sole trader. Again, these regimes do not encourage entrepreneurship and it may well be that the tax system may not be the most appropriate mechanism for doing so. What they do serve to illustrate is the lack of clear and consistent policy in the Australian tax system, which can only add to its complexity.

³³ See n 12.

³⁴ To give some indication of the extent of the problem, the ATO (at n 12) reported that work to address the cash economy in 2006-07 resulted in \$157M in total tax liability being raised.

³⁵ The take up rate had increased to 25 per cent at the end of 2005. See n 18.

³⁶ For more detail on the changes see Subdiv 152 *Income Tax Assessment Act 1997* and, on the ETO specifically, see Subdiv 61-J of the same Act.

³⁷ Explanatory Memorandum, Tax Laws Amendment (2004 Measures No. 7) Bill 2004.

³⁸ See n 5.

³⁹ See Div 35 *Income Tax Assessment Act 1997*.

⁴⁰ See Div Pt 2-42 Divs 84-87 *Income Tax Assessment Act 1997*.

It is not surprising that Australian taxpayers are among the most agent dependent taxpayers in the world⁴¹ with some 93 per cent of business taxpayers using a tax agent to prepare and lodge their income tax returns.⁴² Small business owners do not have the time or understanding of the tax system to be able to manage their tax affairs. Compliance costs – not just monetary, but time, stress and opportunity costs – have been a critical issue for some time, but more so since the tax reforms on 2000. It has been widely recognised by both academic researchers⁴³ and government⁴⁴ that compliance costs are regressive, with the burden falling disproportionately on small businesses. While the emphasis in Australia to date has tended to on the measurement and financial impact of monetary and time costs, it is becoming increasingly apparent that *all* compliance costs have consequences for the survival and entrepreneurship capability of small business. Further, to some extent the emphasis on measurement has detracted from the underlying need to understand the impact of these costs and of tax reform more generally on small businesses.

In the past there have been comprehensive reviews⁴⁵ that tended to be specifically targeted at increasing the efficiency of small business and reducing (or compensating for) compliance costs, though their recommendations have not always been accepted or adopted, nor is it clear that efficiency has been increased when changes have been made. Given the outcomes of these reviews and the fact that tax reform has continued, it can readily be seen why the need to address the compliance costs for small business still remains on the political agenda. For example, the Federal Treasurer requested the Board of Taxation⁴⁶ in 2004 to undertake a post-implementation review of the effectiveness of the small business CGT concessions and in 2006 to undertake a scoping study of small business compliance costs. Thirty nine recommendations (both legislative and administrative) were forthcoming as a result of the first review and these were (with one exception) accepted by the government and the ATO.

The final report of the second review (i.e. the scoping study into small business compliance costs) has only been recently released. Its focus was on understanding the management practices of ‘micro’ businesses and how they coped with regulatory compliance (not only tax and not only federal government requirements) and was based on a qualitative research design. This review found that the small business sector is extremely diverse and that their compliance costs are influenced by size, turnover and structure of their businesses. Further, tax compliance activities may

⁴¹ OECD, *Forum on Tax Administration: Survey of trends in taxpayer service delivery using new technologies*, (2005) OECD.

⁴² McKerchar, M, ‘The impact of income tax complexity upon practitioners in Australia’ (2005) 20 *Australian Tax Forum* 529.

⁴³ See for example Pope, J, Fayle, R and Duncanson, M, *The Compliance Costs of Personal Income Taxation in Australia 1986/87*, (1990); Pope, J and Fayle, R, ‘The Compliance Costs of Public Companies’ Income Taxation in Australia 1986/87: Empirical Results’ (1991) 8 *Australian Tax Forum* 485; Evans, C, Ritchie, K, Tran-Nam, B and Walpole, M, ‘A Report into Taxpayer Costs of Compliance’ (1997) ATO.

⁴⁴ Howard, J, ‘A Statement by the Prime Minister The Hon. John Howard MP, More Time for Business’, 24 March 1997 available at

<http://www.pc.gov.au/orr/reports/external/mtfb/index.html.050311>

⁴⁵ The Taxation Review Committee (Asprey Committee) commenced in 1972; Small Business Regulation Taskforce (Bell Taskforce) commenced in 1996 and the Review of Business Taxation (Ralph Review) commenced in 1998.

⁴⁶ The Board of Taxation was established in 2000 following a recommendation of the Ralph Review (see note 45). The Board is an independent body that advises the government on the formulation and development of tax policy.

provide benefits to business by imposing a discipline that allows them to better monitor and understand their business dealings and cash flows.⁴⁷ These more recent studies provide useful insights into both the drivers and consequences of compliance costs for small business which, in turn, should assist governments in fostering more effective management practices in the small business sector and thereby facilitate greater entrepreneurship.

IV RESEARCH

Early research into the impact of tax reform on small businesses in Australia focused on the measurement and incidence of compliance costs and tended to be quantitative in nature. The works of Pope *et al* and of Evans *et al* were ground breaking at the time and found that compliance costs were very high, though the ATO was critical of the methodology used (particularly in respect of the estimation and valuation of taxpayers' time costs). In many respects the criticisms (which focused on measurement) were unfortunate in that they drew attention away from the extent and significance of the issue of the costs themselves. The valuation of owners' time spent on compliance activities has been contentious given its subjectivity.⁴⁸

Wallschutzky and Gibson⁴⁹ undertook the first qualitative study in Australia on small business compliance costs, basing their work on Yin's⁵⁰ case study strategy of inquiry. Wallschutzky and Gibson⁵¹ concluded that, based on their research (using diaries and interviews over a 12 month period), small businesses found that tax compliance was not difficult nor time consuming and that the tax compliance issue was overstated. One of the common criticisms of their work was the limited number of cases (12), their representativeness, and the extent to which broader analytical generalisations could be made.

A later large scale study was commissioned by the ATO and conducted by Evans *et al*⁵² in 1995-1996. This study was quantitative in nature and included a survey of 10,000 taxpayers. It was found that overall, compliance costs were significant and for business taxpayers, represented (at the time) 9.4 per cent of all federal tax revenue and 1.02 per cent of GDP.

It is important to bear in mind that these studies preceded the introduction of the GST and other major reforms that accompanied it from 1 July 2000. Subsequent research needed to clearly identify those compliance costs that were transitional and those that were ongoing in order to gauge the impact of the reforms. Rametse and Pope⁵³ surveyed 868 small businesses in Western Australia in September/October 2000, just after the introduction of the GST. They found that the average gross start-up cost was \$5,006 (excluding time costs) and \$7,626 (including time costs). The average time spent per business in preparing to comply with the GST requirements

⁴⁷ The Board of Taxation at n 10. Also see Lignier, P, 'A silver lining in the tax compliance cost cloud? A study of the managerial benefits of tax compliance in small business' (2006) paper presented at the 7th International Tax Administration Conference, UNSW, Sydney 20-21 April.

⁴⁸ See Evan *et al* at n 43.

⁴⁹ Wallschutzky, I and Gibson, B, 'Small Business Cost of Tax Compliance' (1993) 10 *Australian Tax Forum* 511.

⁵⁰ Yin, R, *Case Study Research: Design and Methods* (2nd edn 1989).

⁵¹ See n 49.

⁵² See n 43.

⁵³ Rametse, N and Pope, J, 'Start-up Tax Compliance Costs of the GST: Empirical Evidence from Western Australian Small Businesses' (2002) 17 *Australian Tax Forum* 407.

was 131 hours. The research also confirmed that the GST start up costs were regressive.

Tran Nam and Glover⁵⁴ undertook a mixed method approach (survey and semi-structured interviews) to estimate the transitional compliance costs of the GST. They found that small businesses were considerably stressed during the transitional period, but that owners did report an improvement in stress levels in the immediate following year which was attributed to them having 'learnt by doing'. Tran Nam and Glover found that the mean gross transitional cost was \$7,700, a similar result to Rametse and Pope and well short of the \$200 compensation the Federal Government gave each business at the time. However, based on their interviews, Tran Nam and Glover found that *time* was the main transitional compliance cost issue for small businesses.

Drever and Hartcher⁵⁵ studied the impact of the GST on small businesses 12 months after its implementation with an emphasis on the impact on management practices. Using a large scale survey⁵⁶ of both manufacturing and service industries, they found that the GST had had a compounding effect on cash management practices with respondents typically reporting their concerns about the control of creditors and debtors in the following manner: '*Payments of our invoices are a lot slower*' and '*Debtors are slower to pay their accounts*'. Comments in relation to paying on time included: '*Most businesses are reluctant to pay on time which has a flow on of us not being able to meet our creditor payments on time*' and '*Payments of our invoices are a lot slower. We are slower paying*'.

The timing of receipts and payments is clearly an issue in terms of managing cash flow. However, where businesses chose to account for GST on a cash accounting basis in order to better manage cash flow and minimise compliance costs, they may have jeopardised, to some extent, their ability to manage their debtors. This is a cause for concern in that the management of accounts receivable is paramount to the survival and success of every business.⁵⁷ There are numerous examples in the media of the seriousness of this threat to liquidity, from the level of small business tax debt as discussed previously, to the record rise in the number of small business bankruptcies in Australia which doubled from 2,088 in 1988-1989 to 3,899 in 1999-2000, having reached a peak of 5,905 in 1998-1999.⁵⁸

Drever and Hartcher⁵⁹ found that cash flow management was a problem experienced by small businesses. Comments in this regard included: '*Business in this area fluctuates dramatically and if cash flow decreases the quarterly GST, PAYG and superannuation and personal tax payments are quite difficult to meet – sometimes it's not feasible to put enough in a separate account and still pay creditors on time*'. There was evidence that, with the introduction of the GST, having to report business activity every three months provided the small business owner with a better idea of how the business was operating particularly in respect of its cash flow management. For example, it was reported that '*tax and GST is paid together with the one account,*

⁵⁴ Tran-Nam, B and Glover, J, 'Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach' (2002) 17 *Australian Tax Forum* 499.

⁵⁵ Drever, M and Hartcher, J, 'Cash Management in Rural SMEs (New South Wales, Australia)' (2003) paper presented at the 48th World Conference International Council of Small Business, Belfast, Ireland, 13-16 June.

⁵⁶ The sample size of 3,658 was approximately 28% of the total population for the region drawn from the North Coast of NSW. After excluding for out of frames, a response rate of 12.2% resulted.

⁵⁷ See n 8.

⁵⁸ See n 30.

⁵⁹ See n 55.

and there is no large sum at end of year. This allows us to budget for our personal expenditure’.

Drever and Hartcher⁶⁰ found that small businesses reported that their record keeping practices had improved with the introduction of the GST. This was evidenced by comments including ‘*GST is a great tax! It teaches you to manage the cash or you’ll have no cash*’; ‘*More diligent with account keeping*’ and ‘*Far more time is spent updating records, reconciling all records. Instead of doing annual tax returns we had to employ an extra person, part-time to cope with extra work-load. The additional time spent has caused stress on business and family*’.

Drever and DeVries⁶¹ found that Australian entrepreneurs expected a high standard of professional advice on taxation matters, and more consistently than did their counterparts in New Zealand. In particular, Australian entrepreneurs required accurate and useful advice on taxation and on how they might more efficiently manage their businesses. They were concerned with strategies that would allow them to minimise overheads. Where the business employed an accountant, there was the expectation that the accountant would participate in the management of the business, not be just the bookkeeper. Some felt that their accountants were not aggressive enough in advising the partners on the progress of the business. New Zealand entrepreneurs were divided about the use of advisors. Many used a variety of advisors including accountants, bankers and mentors; but as one respondent stated ‘*Didn’t tend to use advisors much – I probably didn’t really appreciate the fact that they could be useful.*’

Drever and DeVries⁶² also found that some Australian entrepreneurs expressed concern about their accountants and saw them as particularly useful for tax advice, however, were extremely critical about their general apparent lack of interest in the business generally. Some also expressed concern about the conservative nature of the advice given by their solicitors.

In spite of the recognition of the benefits and the necessity for small businesses to adopt sound management practices, it appears that there is still considerable scope for improvement. Part of the challenge is for small businesses to manage their limited resources, be they time, money or staff, more effectively to ensure business survival, and at the same time, be entrepreneurial in their outlook and practices. It appears that small businesses are finding it very difficult to make real progress in entrepreneurship and longer-term vision and that further government intervention may be necessary. Given their fundamental importance to the country as a whole, policymakers and administrators have to give immediate consideration to developing a sound understanding of the sector and then focus on the implementation of appropriate strategies to allow entrepreneurship to develop and thrive.

V ANALYSIS

There are three key reasons why the needs of small businesses in Australia have not been met by successive federal governments and their tax reforms. Firstly, the sector (which comprises almost all of Australian businesses) is not homogenous and insufficient attention is given to the consequences of reforms on the various subsets of

⁶⁰ Ibid.

⁶¹ Drever, M and DeVries, H, ‘What are the different attributes between entrepreneurs in Australia and New Zealand?’ (2007) paper presented at the Australian Graduate School of Entrepreneurship Conference, Brisbane, 7-9 February.

⁶² See n 61.

'small business' (whether they be categorised by age, industry type, location or other dimensions). This problem is exacerbated, at least in respect of tax reforms, by an apparent lack of understanding of how small businesses operate and the likely effect of reforms on these practices. For example, the initial requirement of STS to use cash accounting was at odds with good management practices for businesses with debtors and creditors. Similarly, the ability to account for GST on a cash basis and income tax on an accruals basis requires a more complex (and costly) accounting system than many small business operators are able to manage (or need) themselves.

Secondly, the underlying tax policies are unclear, at times conflicting, and subject to ongoing change. For example, on one hand the tax system appears to encourage entrepreneurship by the means of a tax offset, but other regimes (such as non-commercial losses and personal services income, both post 2000) already exist that appear to be in direct conflict with the intent of the offset. Further, the restrictions on turnover and the rate of offset appear to be set very low and as such may not offer any real encouragement to the budding entrepreneur.

An offset to promote entrepreneurship appears to have merit, but it would need to be more widely available and at a higher rate if real benefits are to accrue. It may be that the tax system is not the appropriate mechanism for fostering entrepreneurship and that other forms of direct incentives based on different factors (such as length of time in business, industry type or the number of employees) may be more appropriate than turnover.

Lack of clear and consistent tax policy has led to ad hoc changes and the need for remedial legislation and administrative intervention.⁶³ The rate of change has made it very difficult for small business taxpayers to really benefit from 'learning by doing' when time is a scarce commodity, and expensive if compliance obligations are to be met.

This leads back to the fundamental question of the clarity of policy intent – what is the purpose of the offset? Is it to foster entrepreneurship or is it to compensate small businesses for the regressive nature of compliance costs? If it is the former, then the point has already been made that the offset appears to miss this mark. If it is the latter, then a direct compensatory payment may be more effective than an offset based simply on turnover. However, given that research in Australia to date indicates that time is the most costly aspect of compliance, then it may be that neither a direct monetary compensation nor a tax saving could prove to be effective.⁶⁴

There is a danger that, similar to the debate on the method of measuring compliance costs that delayed any progress on addressing the problem of how to reduce them, the focus on compensation for compliance costs deflects attention from the third and most fundamental problem, that is, not enough is being done by governments to assist small businesses in developing better management practices and to prosper. There have been reviews and much rhetoric on reducing regulation and red tape, but given the structure and nature of government in Australia, it is difficult to hold wholly any one government responsible for the problem. The reduction and harmonisation of regulatory requirements will require serious dialogue, strategies and vision between

⁶³ McKerchar, M, Meyer, K and Karlinsky, S, 'Making Progress in Tax Simplification: A Comparison of the United States, Australia, New Zealand and the United Kingdom' in McKerchar, M and Walpole, M (Eds) *Further Global Challenges in Tax Administration* (2006) 367.

⁶⁴ Given the lack of agreement in the extant literature (see for example Evans *et al* at note 43) on how compliance costs should be measured, it is difficult to determine how much compensation, by way of the ETO, is necessary.

all levels of government if any real improvements are to be made. But this is only one aspect where assistance by government could develop better strategies to benefit small business and allow them to be more competitive in the global marketplace. There is considerable scope for clear and well developed government policies directed at encouraging small businesses to be more entrepreneurial, more competitive internationally, and to be better managers of their records, their business activities, and their cash and other liquid assets.

VI CONCLUSION

Australian tax laws are complex, as they are in many other regimes. While complex tax laws affect all taxpayers, it is clear that small business taxpayers, which represent a large and vital sector of the Australian economy, bear more than their share of the burden of compliance costs. While much attention has been given by government, policy makers, administrators and researchers to identifying and measuring the costs of compliance and their incidence, there remains a great deal of work to be done to understand these costs, their effects on business practices and entrepreneurship, and how these costs be reduced and/or greater efficiencies and gains be achieved. Valuable lessons can be learnt from the entrepreneur as to what is best and most efficient and effective practice in preparing and utilising reports prepared for tax purposes. The three level structure of government and its lack of co-ordination, communication and commitment is a key reason for the failure to address the level of regulation which applies to the small business sector in Australia. Whilst the focus of the paper has been on federal taxation, there are many other aspects of regulation – including superannuation, workers compensation and occupational health and safety – that impose enormous burdens on small business and which undergo numerous changes with scant consideration of how these changes will impact on small businesses.

There is a need for governments, policy makers, administrators and researchers to develop a better understanding of small businesses and their management practices. Policy intent needs to be articulated more clearly and with consistency, and changes (where necessary) need to be made in the context of a more strategic vision for the small business sector and an overriding goal to make it as simple as possible for small business to be better managed and to thrive. Further research should centre on how the entrepreneur understand the income tax and goods and services returns and what impact it has had on their businesses.

Further research is necessary in understanding the Australian small business sector as a whole, how they conduct their businesses and how their tax compliance obligations can be better utilised to further stimulate entrepreneurship. There is also a need for policymakers and other stakeholders to have a greater understanding of the needs, practices and diversity of the small business sector. This requires the adoption of a much wider policy perspective (i.e. not just tax in isolation) so that integration is achieved and consequences foreseen and taken into account. With this greater understanding more informed and effective policies can then be developed and the longer term sustainability of the sector enhanced. Finally, as part of the need for integrated government policies, it will be essential to have further research conducted on the drivers of entrepreneurship (such as the effectiveness of the tax offset) and how it can be more effectively encouraged by engaging accountants to provide proactive strategies for their respective challenges for the small business sector.

THE DISTINCTION BETWEEN TAX AVOIDANCE AND TAX EVASION HAS BECOME BLURRED IN AUSTRALIA: WHY HAS IT HAPPENED?

JOHN MCLAREN*

The distinction between tax avoidance and tax evasion has been well established in the Australian taxation system. However, for some time the Australian Government has ignored the difference between the two concepts when it comes to Australians using tax havens and being investigated as part of 'Project Wickenby'.¹ The Australian Government is deliberately labelling all attempts to minimise income tax through the use of tax havens and offshore financial centres (OFCs) as tax evasion and therefore a criminal act. There have been examples quoted in the press where the Australian Crime Commission, conducting investigations as part of 'Project Wickenby', have gained access to Swiss bank records on the basis that the Australian taxpayer has been involved in suspected tax fraud when this was not the case.² Is this one of the main reasons why the Australian Government is ignoring the distinction in order to detect money held in tax havens? This paper will examine the distinction between the two concepts and try to provide an answer for the approach being taken by the government.

I INTRODUCTION

The Australian statutory law as well as the common law recognises the important distinction between taxpayers engaging in conduct that constitutes tax avoidance and conduct that constitutes tax evasion. However, for some time the Australian Government has ignored the difference between the two concepts when it comes to Australians using tax havens and being investigated as part of 'Project Wickenby'.³ For example, the law to deter the promotion of tax schemes, Division 290, of the *Taxation Administration Act 1953* (Cth) ignores the distinction between tax avoidance and tax evasion and deals with 'tax exploitation schemes' instead. The *Anti-Money Laundering and Counter Terrorism Financing Act 2006* (Cth) (AML/CTF Act) is another example of the blurring of the distinction between tax avoidance and tax evasion because it allows government agencies to detect Australian taxpayers using tax havens by requiring their accountants, lawyers and financial advisers to report 'suspicious transactions' that involve the transfer of money between tax havens and

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¹ 'Operation or Project Wickenby' is the name given to a joint operation involving the Australian Crime Commission (ACC), the Australian Taxation Office (ATO) and the Australian Securities and Investment Commission (ASIC) investigating the use of tax havens by Australian taxpayers in what is alleged as criminal activity.

² Matthew Drummond, 'Wickenby blunder taints tax inquiry', *Australian Financial Review*, Sydney, 22 March 2007, 1.

³ 'Operation or Project Wickenby' is the name given to a joint operation involving the Australian Crime Commission (ACC), the Australian Taxation Office (ATO) and the Australian Securities and Investment Commission (ASIC) investigating the use of tax havens by Australian taxpayers in what is alleged as criminal activity.

Australia. These two examples of statutory law are clear examples of the Australian Government deliberately labelling all attempts to minimise income tax through the use of tax havens and offshore financial centres (OFCs) as tax evasion and therefore a criminal act. There have been examples quoted in the press where the Australian Crime Commission, conducting investigations as part of 'Project Wickenby', have gained access to Swiss bank records on the basis that the Australian taxpayer has been involved in suspected tax fraud when this was not the case.⁴ If tax minimisation can be held to constitute a criminal act then tax havens and OFCs can be encouraged to disclose bank account details of Australian taxpayers in that country. Is this one of the main reasons why the Australian Government is ignoring the distinction between tax avoidance and tax evasion in order to detect money held in tax havens? This paper will examine the distinction between the two concepts and try to provide an answer for the approach being taken by the government.

In 2004 Justin Dabner contended that the OECD's campaign against 'harmful tax competition' was trying to 'criminalise tax avoidance' by attempting to group tax evasion and tax fraud with legitimate tax avoidance in order to achieve their outcome of deterring tax competition between countries, especially tax havens.⁵ For example, the law to deter the promotion of tax schemes, Division 290, *Taxation Administration Act 1953* (Cth) ignores the distinction between tax avoidance and tax evasion and deals instead with 'tax exploitation schemes'. The *Anti-Money Laundering and Counter Terrorism Financing Act 2006* (Cth) (AML/CTF Act) is another example of the blurring of the distinction between tax avoidance and tax evasion and this will be examined in detail later in the paper. It is contended that the Australian Government, the OECD⁶ and the Financial Action Task Force (FATF)⁷ are deliberately labelling all attempts to legally minimise income tax through the use of tax havens and offshore financial centres (OFCs) as tax evasion and therefore a criminal act.

If all tax minimisation activity amounts to a criminal act then tax havens and the OFCs can be encouraged to disclose information on foreign investments in their country and justify breaching their own bank secrecy laws. All banks have strict laws that govern their ability to disclose information about their customers.⁸ However, in the case of criminal activity, information can be provided to foreign government agencies.⁹ Tax evasion constitutes the crime of fraud which in turn amounts to the act of 'defrauding of the Commonwealth'. Hence, utilising the services of an OFC or a tax haven may also constitute the crime of money laundering. This would appear to be the reason why the Australian Government needs to blur the distinction between tax avoidance and tax evasion and therefore to be able to obtain banking details from

⁴ Matthew Drummond, 'Wickenby blunder taints tax inquiry', *Australian Financial Review*, Sydney, 22 March 2007, 1.

⁵ Justin Dabner, 'An update on the OECD's harmful tax practices project' (2004) 40 *CCH Tax Week*, 4.

⁶ OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998) OECD.

⁷ The Financial Action Task Force (FATF) is located within the OECD in Paris but was established to actively prevent money laundering.

⁸ It is not intended to discuss the law relating to the relationship between a bank and its customer other than to emphasise that both statutory law and common law provides strict codes of conduct in relation to the confidentiality of bank details. An excellent discussion of the importance of bank secrecy and the laws that try to ensure that customer information is kept confidential can be found in the OECD document, 'Improving Access to Bank Information for Tax Purposes' (2000) OECD, 19.

⁹ OECD, 'Financial centres become more transparent, but information exchange remains a problem for some', 29 September 2008. The OECD acknowledged that in 78 of the 83 OECD and non-OECD economies, they now provide banking information in relation to requests involving criminal tax matters. Accessed www.oecd.org on 7 November 2008.

other countries on the basis that all tax minimisation activity amounts to criminal conduct, irrespective of whether it is 'tax avoidance' or 'tax evasion'.

The paper commences with a discussion on the distinction between tax avoidance and tax evasion in Australia and then critically examines the current approach of the Australian Government to ignore the difference between the two concepts. It is argued in this paper that there has been a deliberate move by the Australian Government to treat tax avoidance as amounting to tax evasion and to ignore the legal distinction between the two activities.

II THE AUSTRALIAN APPROACH TO 'TAX AVOIDANCE AND TAX EVASION'

It is generally acknowledged that tax evasion constitutes an act outside the law whereas tax avoidance is considered an act within the law. This basic principle of taxation law is supported by the definitions of tax avoidance and tax evasion contained in 'The Taxation Review Committee' Report, Australia 1975, which is commonly referred to as the 'Asprey Committee Report'.¹⁰ According to I. G. Wallschutzky,¹¹ the following definitions are based on those used in the 'Carter Commission' Report¹² and the definitions contained in the UK 'Radcliffe Commission'.¹³

The phrase 'tax evasion' describes an act in contravention of the law whereby a person who derives a taxable income either pays no tax or pays less tax than he would otherwise be bound to pay. Tax evasion includes the failure to make a return of taxable income or the failure to disclose in a return the true amount of income derived. ... 'tax avoidance', on the other hand, usually connotes an act within the law whereby income, which would otherwise be taxed at a rate applicable to the taxpayer who but for that act would have derived it is distributed to another person or between a number of other persons who do not provide a bona fide and fully adequate consideration; in the result the total tax payable in respect of that income is less than it would have been had no part of the income had been distributed and the whole been taxed as the income of that taxpayer.¹⁴

The definitions of 'tax evasion' and 'tax avoidance', as quoted above, are no different from the definitions used in both Canada and the UK. According to I.G. Wallschutzky, the [two types] of tax avoidance are within the law and are therefore different from instances of evasion which are outside the law.¹⁵ Not all commentators believe that the distinction is always clear. Professor Logue contends that the distinction is 'notoriously fuzzy', but reinforces the fact that tax evasion usually

¹⁰ Commonwealth of Australia, 'The Taxation Review Committee', Australia 1975. The report can be found at the University of Sydney Library, accessed 17 November 2008. <http://purl.library.usyd.edu.au/setis/id/p00087>

¹¹ Wallschutzky, I. G., 'Towards a Definition of the Term "Tax Avoidance"' (1985) 14 *Australian Tax Review* 48, 52.

¹² The Royal Commission on Taxation, Canada 1966, commonly referred to as the 'Carter Commission'.

¹³ The Royal Commission on Taxation of Profits and Income, 1955, commonly referred to as the 'Radcliffe Commission'.

¹⁴ Asprey, K. W. and Parsons, Ross, 'Taxation Review Committee' 1975, University of Sydney Library 2001, Chapter 11- Income Splitting, Paragraph 11.1, 215.

¹⁵ Wallschutzky, I. G. n 9, 55. The reference to the two types of avoidance contained in the Asprey Committee's Report are referring to types of tax avoidance intended to be covered by the legislature and those types of avoidance which are not covered by the legislature.

involves an ‘element of intentionality on the part of the taxpayer’.¹⁶ An example of this is provided by Professor Logue with a wealthy individual hiding income in a foreign bank account in a manner that is clearly not allowed by U.S. tax law. In that case the taxpayer is clearly a tax evader.¹⁷ Logue then suggests that tax avoidance could be simply defined as ‘arranging your affairs to minimise your taxes in a manner that is consistent with the law’.¹⁸

If the law relating to the distinction between tax evasion and tax avoidance was that simple, and it is contended in this paper that it should be that simple, then the government has no basis for treating tax minimisation and tax avoidance as constituting tax evasion, and thus a criminal activity. The next step in the examination of this area of taxation law is to review the current statutory law in Australia.

A Statutory Law Approach

In Australia the anti-avoidance measures are contained in a number of ‘General Anti-avoidance Rules’, GAARs. According to Professor Evans, these GAARs are found in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 36), Section 67 of the *Fringe Benefits Tax Assessment Act 1986* (Cth) and Division 165 of the *New Tax System (Goods and Services Tax) Act 1999* (Cth).¹⁹ Professor Evans discusses the ‘shotgun and sniper’ approach to the specific statutory anti-avoidance provisions, SAARs, aimed at tax avoidance such as section 26-54 of the ITAA 97 relating to tax deductions incurred in criminal activities and section 86-10 of the ITAA 97 relating to preventing the alienation of personal services income through companies, partnerships or trusts.²⁰ Evans contends that in Australia there is a ‘reliance on GAARs, SAARs and the promoter penalty regime, all bounded together in a carefully crafted risk management strategy’.²¹ The tax scheme promoter penalty regime will be critically examined later in this paper as an example of the blurring of the distinction between tax evasion and tax avoidance. However, it is important to note that the promoter penalty regime is seen as a major weapon being used by the government to combat tax avoidance in Australia. Similarly, the concept of a ‘risk based’ approach to managing tax avoidance will be discussed later in the paper under the heading of ‘other approaches to tax avoidance’, as many countries are using this system to try to overcome tax minimisation through abusive tax avoidance and tax mitigation schemes.

The statutory law does not provide a definition of what constitutes ‘tax evasion’ or ‘tax avoidance’. A definition of tax avoidance is found in s 82KH(1) of the ITAA 36, but as Ian Wallschutzky states, it is only relevant for the sub-division in which it appears.²² In fact, the GAAR provisions contained in Part IVA, of the ITAA 36, do not provide a definition of what constitutes tax avoidance. At best, the provisions exhaustively define what is a ‘tax benefit’ pursuant to s 177C(1). There is no mention of what might be considered to be acceptable tax avoidance or what is regarded as

¹⁶ Logue, Kyle D, ‘Tax Law Uncertainty and the Role of Tax Insurance’ (2005-2006) 25 *Virginia Tax Review*, 339, 353.

¹⁷ *Ibid*, 354.

¹⁸ *Ibid*, 355.

¹⁹ Evans, C, ‘The Battle Continues: Recent Australian Experience with Statutory Avoidance and Disclosure Rules’, in Judith Freeman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 37, 38.

²⁰ *Ibid*, 42.

²¹ *Ibid*, 46.

²² Wallschutzky, I, n 9, 49.

abusive tax avoidance. The GAAR provisions do not make any distinction at all. In the context of the Commissioner of Taxation being empowered to amend a taxpayers' assessment of taxation, s 170(1) of the ITAA 36 provides that in the case of avoidance of tax due to fraud or evasion, there is no limit on the time in which the assessment can be amended. In the case of tax avoidance, the time limit is now four years from the date of the original assessment for the Commissioner to amend the assessment.²³ The section does not attempt to provide any type of definition of tax avoidance or tax evasion. In order to obtain an explanation of the type of activity that constitutes tax evasion or tax avoidance it is necessary to look to the common law in order to see how the courts in Australia have interpreted this area of the statutory law.

B The Common Law Approach

The common law in Australia is regarded as being settled on the distinction between 'tax avoidance and tax evasion'. In the case of *R v Mears*,²⁴ the NSW Court of Criminal Appeal, when considering an appeal against the severity of a sentence for an action pursuant to s 86A, *Crimes Act 1914* (Cth), conspiracy to defraud the Commonwealth, Gleeson CJ made the following statement on the distinction between tax avoidance and tax evasion:

Although on occasion it suits people for argumentative purposes to blur the difference, or pretend that there is no difference, between tax avoidance and tax evasion, the difference between the two is simple and clear. Tax avoidance involves using or attempting to use lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful. Although some people may feel entitled to disregard the difference, no lawyer can treat it as unimportant or irrelevant. It is sometimes said that the difference is difficult to recognise in practice. I would suggest that in most cases there is a simple test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.²⁵

If the former Chief Justice of the High Court, Gleeson CJ believes that the distinction is so important for lawyers and the courts, then why has the government been prepared to overlook this important distinction? A further example of the court considering the distinction between tax avoidance and tax evasion is found in *Denver Chemical Manufacturing Co v DCT* (NSW). The judgment of Dixon J provides an excellent description of the conduct required to constitute tax evasion by a taxpayer.

I think it is unwise to attempt to define the word 'evasion'. The context of s 210(2) [now s 170(1), ITAA 36] shows that it means more than avoid and also more than a mere withholding of information or the furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated. An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.

In the present case the Board concluded that the appellant intentionally omitted the income from the return and that there was no credible explanation before them why he did so. They thought that the conduct of the taxpayer answered the description of an avoidance of tax by evasion.²⁶

²³ Section 170(1) Item 5 for tax evasion and Item 4 for tax avoidance.

²⁴ (1997) 37 ATR 321.

²⁵ *Ibid*, 323.

²⁶ (1949) 79 CLR 296, per Dixon J, 313.

Dixon J agreed with the earlier finding of the NSW Court of Appeal in that the actions of the Appellant amounted to tax evasion. However, it should also be noted that the actions which might be regarded as constituting tax evasion and tax avoidance can arise in more situations than those involving the withholding of information or the provision of misleading information. Dealing in cash, as part of the 'black economy',²⁷ to avoid paying tax on income is more than withholding information but still constitutes tax evasion.

In the recent case of *Kajewski v Federal Commissioner of Taxation*,²⁸ the Commissioner of Taxation alleged tax avoidance through fraud and evasion. The taxpayer argued that the alleged fraud and evasion resulted from actions taken by their tax agent and that they were not aware of the situation that gave rise to the allegation. Section 170(2)(a), ITAA 36 [now s 170(1)] provides the Commissioner with the power to issue an amended assessment at any time if the avoidance of tax is due to fraud or evasion. The taxpayer also contended that 'even if their original assessments were affected by fraud or evasion within s 170(2)(a), it was not fraud or evasion in which they personally engaged and that s 170(2)(a) did not therefore empower the Commissioner to issue the amended assessments in October 1999'.²⁹ Drummond J made the following comment on the distinction between tax avoidance and tax evasion:

There will be "an avoidance of tax" within this provision where, without any active or passive fault on the part of the taxpayer, less tax has been paid than ought to have been paid. See, eg, *Australasian Jam Company Proprietary Limited v FCT* (1953) 88 CLR 23 at 34; 10 ATD 217 at 222. Fraud within s 170(2)(a) involves something in the nature of fraud at common law, i.e., the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.³⁰

Drummond J also quoted from the judgment by Dixon J in *Denver Chemical Manufacturing Company v Commissioner of Taxation (New South Wales)*, and confirmed that His Honour's analysis was the most appropriate in determining the type of conduct that amounted to fraud or evasion on the part of a taxpayer. From the above limited examination of the common law, it can be seen that tax evasion can be clearly distinguished from tax avoidance and that tax evasion involves the taxpayer being engaged in conduct outside the law with an intention to not pay the required amount of tax by fraud or reckless behaviour. If the courts in Australia have no difficulty in distinguishing between tax evasion and tax avoidance, what then is the approach of other countries to this issue?

C Other approaches to tax avoidance

One of the main criticisms of having a GAAR is that the legislature has a particular view of the type of conduct that may constitute tax avoidance on the part of the taxpayer. However, the judiciary does not always interpret and apply the law in the same way as was intended by Parliament.³¹ Tim Edgar explores this dilemma in his paper and strongly contends that it 'is hopeless to leave it to the judiciary to articulate

²⁷ The term 'black economy' is commonly used in Australia to denote business conducted in cash in order to avoid any evidence of the receipt of income so as to avoid the payment of income tax or the Goods and Services Tax (GST) constitutes tax evasion.

²⁸ (2003) 52 ATR 455.

²⁹ Ibid, 483.

³⁰ Ibid, 484.

³¹ Edgar, Tim, 'Building a Better GAAR' (2007-2008) 27 *Virginia Tax Review* 833, 837.

a behavioural prohibition that is neither under-inclusive nor over-inclusive in its identification of prohibited transactions'.³² He advocates the design of a GAAR by reference to a 'business-purpose test' with emphasis on the different concepts of the economic substance associated with the categories of tax avoidance behaviour, such as tax evasion, acceptable tax avoidance and abusive tax avoidance.³³ By way of illustration, Edgar states that the Canadian GAAR has at its core, a distinction between 'acceptable' and 'abusive' tax avoidance and this is seen by some commentators as providing an 'overly-broad category of acceptable tax avoidance and ... an under-inclusive category of abusive tax avoidance'.³⁴ Acceptable tax avoidance is sometimes referred to in the literature as 'tax mitigation' or 'tax minimisation' whereas abusive tax avoidance is seen as involving schemes that are 'contrived' or 'artificial'.³⁵ The Australian GAAR does not provide that level of distinction and it is then left to the judiciary to determine those differences.

It could be argued that with the deliberate blurring of the distinction between tax evasion and tax avoidance in Australia that the Canadian approach may be seen as a desirable way of maintaining a distinction between acceptable tax avoidance and abusive tax avoidance. Acceptable tax avoidance is clearly seen to be within the law, whereas abusive tax avoidance, which may be outside the law, is properly treated as being similar to tax evasion.

Furthermore, the OECD in its 'Study into the Role of Tax Intermediaries', has introduced the 'notion of aggressive tax planning into the international tax lexicon',³⁶ and draws a distinction between acceptable tax avoidance such as tax mitigation and minimisation and aggressive tax planning involving sham transactions. The OECD study looks at the supply side of aggressive tax planning solutions, being provided by tax intermediaries such as accounting and law firms, and the taxpayers representing the demand side of the tax minimisation products.³⁷ Aggressive tax planning is defined as: 'planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences, and taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law'.³⁸ It is contended that 'the test of whether tax planning is "acceptable" should be what the legislation says as interpreted by the courts, and not what the tax authorities suppose it was intended to say'.³⁹ This issue is highlighted in Part V under the heading of 'Implications for the Rule of Law'. The approach taken by the OECD in their study into 'tax intermediaries' adds further weight to the argument that the current approach to tax mitigation and tax evasion in Australia, and internationally, is threatening the fundamental principle of the importance of the 'rule of law' in all legal systems throughout the world.

It is obvious that tax intermediaries have always created a problem for organisations such as the OECD and many countries with the promotion of tax havens and OFCs as a means of reducing the effect of taxation on multi-national corporations and high net worth individuals. As discussed below in this paper, the OECD has been deliberately

³² Ibid, 837.

³³ Ibid, 837.

³⁴ Ibid, 878, 879 and footnote 100.

³⁵ Ibid, footnote 96, 878.

³⁶ Freedman, Judith, Loomer, Geoffrey and Vella, John, 'Alternative Approaches to Tax Risk and Tax Avoidance: Analysis of a Face-to-Face Corporate Survey' (2008) Working Paper 08/14, *Oxford University Centre for Business Taxation*, 2.

³⁷ OECD, 'Study into the Role of Tax Intermediaries' (2008) OECD, 5.

³⁸ Ibid, 10.

³⁹ Freeman, Judith et al, n 32, 3.

blurring tax evasion and tax avoidance, but this current study by the OECD would appear to put all activities used to mitigate tax within the category of 'abusive tax avoidance' and unlawful conduct, and therefore amounting to criminal tax activity. The OECD approach can be seen as another attempt to criminalise tax avoidance by creating an artificial distinction between tax mitigation, on the one hand, and aggressive tax planning, on the other hand, while all the time ignoring the clear cut distinction between tax evasion and tax avoidance that has existed in the law of many of the OECD member countries based on the Anglo-US legal system.

One of the features of the OECD study into tax intermediaries is the discussion of the need for effective risk management by the tax authorities, and the OECD sees that as an important method to prevent tax avoidance by intermediaries. In fact, Australia and the UK⁴⁰ have already adopted a risk-based approach to try to combat tax avoidance. As Anita Paddock and Chris Oates state, '[o]ne of the main drivers in the ATOs risk-profiling process is the perceived willingness of the corporate to use marketed tax mitigation in its tax planning programme'.⁴¹ If tax authorities engaged in cooperative discussions with corporations and high net worth individuals as part of a risk management program to encourage disclosure of tax mitigation arrangements, then there may not be a need to rely on the legislature, and the courts, to prevent tax avoidance after the event. In turn, this may alleviate the need to engage in the tactic of declaring all forms of tax minimisation as constituting criminal activity.

III THE INTERNATIONAL APPROACH TO THE DISTINCTION BETWEEN 'TAX AVOIDANCE AND TAX EVASION'

International bodies such as the OECD, the Financial Action Task Force, (FATF) and the Economic Union, (EU) have been actively involved in trying to limit harmful tax competition by tax havens and OFCs. By grouping tax avoidance and tax evasion as constituting one and the same activity, the international bodies such as the OECD, the Financial Action Task Force, FATF and the EU are able to make the presumption that any financial activity using an OFC or a tax haven must be tax evasion and therefore of a criminal nature. Branson QC⁴² makes the observation that the OECD in its crusade against 'harmful tax competition' has 'not sought to draw any clear or marked difference between evasion and avoidance and in every relevant respect they have been treated as one homogenous subject'.

The OECD report on harmful tax competition, paragraphs 53 and 54⁴³ do not attempt to clearly distinguish between tax avoidance and tax evasion when discussing the need for tax havens to become more transparent and to exchange information. In paragraph 53, the OECD makes the following comment:

[B]ecause non-transparent administrative practices as well as an inability or unwillingness to provide information not only allow investors to avoid their taxes but also facilitate illegal activities, such as tax evasion and money laundering, these factors are particularly troublesome.⁴⁴

⁴⁰ The 'Varney Review' in the UK had advocated a risk-based approach to managing the tax risk associated with tax avoidance and large corporations. See the paper by Freeman, Judith et al, n 32 for a discussion on this issue.

⁴¹ Paddock, Anita and Oates, Chris, 'Corporate tax self-assessment lessons from down under' (2003) 14 *International Tax Review* 28, 29.

⁴² Branson, C.C., 'The international exchange of information on tax matters and the rights of taxpayers' (2004) 33 *Australian Taxation Review* 71, 77.

⁴³ OECD, n 4, 23 and 24.

⁴⁴ *Ibid*, 23.

In paragraph 54, the OECD then states that progress has been made in accessing information from tax havens through the entering of ‘mutual legal assistance treaties’ in criminal matters such as criminal tax fraud. According to Peter-Szerenyi, the issue of the exchange of information and transparency should only relate to criminal tax matters:

The lack of exchange of information and transparency facilitates only illegal activity, not tax avoidance. Tax avoidance is legal, whether the home country knows about it or not. Thus, the tax authorities of the home country do not need any information for the correct and timely application of its own tax law. The lack of the two criteria (exchange of information and transparency) in connection with tax avoidance is a problem merely because it makes it difficult for the home country to detect and prevent the use of foreign tax regimes – in other words, to enact laws aimed at combating offshore investments (e.g. CFC rules), Paragraphs 70 and 114.⁴⁵

In the OECD report⁴⁶ on improving access to bank information it was stated that where ‘some countries rely heavily on a self-assessment system to administer their taxation laws...wilful failure of a taxpayer accurately to report income will generally be considered a criminal action.’⁴⁷ In terms of requiring other countries to cooperate in providing access to information, the OECD Report goes on to make the following observation:

With respect to assistance provided to other countries in criminal investigations (including criminal tax investigations), some countries generally apply the principle of ‘double incrimination’. That is, before assistance can be provided to a requesting country, it must be established that the conduct being investigated would constitute a crime under the laws of the requested country if it occurred in the requested country. In the tax area, application of this principle will not generally be an impediment to exchange of information for criminal purposes where the definitions of tax crimes are similar. However, where the definitions of tax crimes in the requesting and requested countries are markedly different, it may be impossible in many cases for the requesting country to obtain information that is vital to a criminal investigation.⁴⁸

In most tax havens tax avoidance is not a crime because as a result of those countries not imposing any form of income tax, there is no tax to avoid. However, the non-payment of income tax by an Australian resident taxpayer on income derived in an offshore bank account can be construed as constituting the act of ‘money laundering’ in Australia, because the proceeds are from a criminal act, namely tax evasion. In the tax havens that have introduced anti-money laundering legislation, tax related criminal activities would constitute a crime under their domestic law, particularly if the requesting country was able to argue that tax avoidance, in any form, was a crime and the subsequent laundering of the money through a tax haven constituting the crime of money laundering. For example, the Cook Islands introduced the *Money Laundering Prevention Act* in 2000 and amended its *Crimes Act* in order to introduce law based on the FATF 40 recommendations which are similar to the anti-money laundering law in Australia.⁴⁹ In that situation, the appropriate banking information about the Australian taxpayer may be supplied by the requested country.

⁴⁵ Peter-Szerenyi, Linda, ‘The OECD’s artificial approach to tax havens: Part 2’ (2003) 14 *Journal of International Taxation* 10, 20.

⁴⁶ OECD, *Improving Access to Bank Information for Tax Purposes*, 2000 OECD, 15, footnote 7.

⁴⁷ *Ibid*, 15, note 7.

⁴⁸ *Ibid*, 15, note 7.

⁴⁹ Financial Action Task Force/ OECD, 2005 Annual Report, 6. Accessed at www.fatf-gafi.org on 21 November 2008.

This is one of the main reasons why the new AML/CTF Act has been introduced by the Australian Government.

The OECD has been successful in convincing Vanuatu, Samoa and Niue to enter into an agreement to exchange information on foreign investors using their offshore financial services. The countries entered into the agreements to exchange information on civil tax matters by 31 December 2005.⁵⁰ Since that time, the OECD has been able to convince a further 83 OECD and non OECD countries to enter into 'Double Tax Conventions' for the exchange of banking information.⁵¹ In the same OECD announcement, it is noted that Belgium has agreed to exchange banking information with the USA in relation to civil and criminal tax matters. This raises the issue of the need for countries such as Australia not only to develop relationships with other countries in order to enter into an agreement for the exchange of banking information, but also the need to classify tax matters as constituting a civil or criminal offence under the domestic law. It is not sufficient to merely classify all types of tax minimisation as constituting abusive tax avoidance and tax evasion on the basis that the investments are held in a tax haven.

When the then Minister for Foreign Affairs, the Honourable Alexander Downer was asked about his attitude to Vanuatu being a 'tax haven' and Australians using Vanuatu to avoid income tax, his answer was as follows:

Well, I'm in favour of low tax and countries have got to make themselves as competitive as they possibly can in a competitive world, but what has worried us in the past has been on the issue particularly of money laundering. And the Vanuatu Government and Vanuatu Parliament has now legislated against money laundering and introduced this anti-money laundering legislation. We see that as a very good step forward but obviously it's going to be a challenge to implement the provisions of the legislation and we're happy to help the Government of Vanuatu in that respect.⁵²

This comment from the former Australian Minister for Foreign Affairs would appear to condone Vanuatu as engaging in tax competition but at the same time taking measures to combat money laundering. It would be assumed that the Vanuatu law is designed to combat illegal tax evasion and not legitimate tax avoidance or minimisation. For the OECD or the Australian Government to impose sanctions as a result of tax avoidance in say Australia, while it is not contrary to the law in Vanuatu, would in fact be a breach of international law.⁵³ To threaten another sovereign nation with sanctions or to terminate existing treaties just because they will not exchange banking information that may or may not be of a criminal nature is potentially a breach of obligations to the World Trade Organisation (WTO) or a breach of Article 54 of the Vienna Convention on the Law of Treaties.⁵⁴ According to Benjamin Hartman, there is 'no necessary connection between low taxes and tax evasion ... therefore, no basis to claims that offering low taxes facilitates crimes'.⁵⁵ He makes this claim on the basis that the tax havens are under no obligation to comply with the

⁵⁰ Linda Peter-Szerenyi, n 32, 18.

⁵¹ OECD, 'Financial centres become more transparent, but information exchange remains a problem for some', 29 September 2008.

⁵² Minister for Foreign Affairs, The Honourable Alexander Downer, MP, Press Conference, Port Vila, Vanuatu, transcript 19 April 2006, accessed at: http://www.foreignminister.gov.au/transcripts/2006/060419_vanuatu.html, on 22 September 2006.

⁵³ Linda Peter-Szerenyi, n 32, 23.

⁵⁴ Hartman, Benjamin, 'Coercing Cooperation from Offshore Financial Centers: Identity and Coincidence of International Obligations Against Money Laundering and Harmful Tax Competition' (2000-2001) 24 *Boston College International & Comparative Law Review* 253, 264

⁵⁵ *Ibid*, 265.

directives issued by the OECD or FATF and non-compliance is not sufficient grounds to impose sanctions under international law.⁵⁶

The introduction of the so-called USA Patriot Act⁵⁷ has not dramatically reduced the use of Caribbean tax havens by citizens of the USA.⁵⁸ OECD and EU member countries still compete in trying to attract capital by reducing income tax rates. There is no 'level playing field'⁵⁹ in the world today and Australia has joined in the tax competition to attract wealthy individuals while 'ring fencing'⁶⁰ its own residents through the recently introduced tax law that applies to 'temporary residents'.⁶¹ It will be interesting to see if the AML/CTF Act introduced into Australia will have a dramatic effect on tax havens. As Eden and Kudrle put it, 'the jury is still out on whether the OECD's attempt to name and shame tax havens as renegade states will be successful.'⁶² The same situation can be said of the following legislative attempts being introduced in Australia to prevent tax minimisation through OFCs and tax havens.

IV AN EXAMPLE OF BLURRING: THE LAW TO 'DETER THE PROMOTION OF TAX SCHEMES'

The Australian Government introduced the law to deter the promotion of tax schemes, with effect from 6 April 2006. The provisions are designed to complement the GAAR.⁶³ This law has the potential to deter the promotion of tax schemes such as those that involve the use of tax havens and OFCs, but it appears that it has deliberately ignored the difference between tax evasion, a criminal offence, and tax avoidance or tax mitigation, legal activity.

A The law used to deter the promotion of tax schemes

The statutory provisions⁶⁴ consist of three main parts, first the imposition of 'civil penalties' on 'promoters' of 'tax exploitation schemes', second; 'injunctions granted

⁵⁶ Ibid, 265.

⁵⁷ The term 'USA Partiot Act' is an anachronism for the Act called the '*Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act*'

⁵⁸ Lorraine Eden and Robert Kudrle, 'Tax Havens: Renegade States in the International Tax Regime', (2005) *Law and Policy*, 100, 123.

⁵⁹ The term 'level playing field' is taken from the OECD, 'Tax Co-operation: Towards a level playing field (2006) OECD, 7. The OECD is determined to achieve a 'level playing field' in the areas of transparency and effective exchange of information for tax purposes, especially with civil and criminal tax matters.

⁶⁰ 'Ring Fencing' is the term used by the OECD, n 4, to denote the existence of tax concessions for foreign investors that are not available to resident taxpayers. For example, temporary residents are not taxed on their foreign sourced income and are taxed as if on a 'territorial' basis. In this case the Australian resident taxpayer is 'fenced in' and not able to take advantage of the same tax concession.

⁶¹ The new law takes effect from 1 July 2006 and is now contained in Division 768, ITAA 97. The law started out as the Taxation Laws Amendment (2006 Measures No.1) Bill 2006 (Cth) and was enacted as Act No.32 of 2006. Section 768-900 provides that 'this Subdivision modifies the general tax rules for people in Australia who are temporary residents, whether Australian residents or foreign residents. The term 'ring fencing' is used to denote tax law that favours non-residents over a countries own residents. In this case temporary residents do not pay income tax in Australia on income derived outside Australia.

⁶² Lorraine Eden and Robert Kudrle, n 34, 124.

⁶³ Evans, C, n 19, 46.

⁶⁴ The new statutory law is found as Schedule 3, starting with Division 290, of TAA 53.

by the Federal Court' to restrain an entity from engaging in promoting schemes, and third; 'voluntary undertakings' given by an entity not to continue promoting schemes.

Sections 290-5 states that: the objects of this Division are:

- (a) to deter the promotion of tax avoidance schemes and tax evasion schemes; and
- (b) to deter the implementation of schemes that have been promoted on the basis of conformity with a product ruling in a way that is materially different from that described in the product ruling.

In the Explanatory Memorandum, the Government advises that the measures are designed to deter the promotion of tax avoidance and evasion schemes, collectively referred to as 'tax exploitation schemes' and to deter the implementation of schemes that have been promoted on the basis of a product ruling being provided by the ATO but the actual scheme is materially different from what was disclosed in the ruling.⁶⁵ The Government justifies the new law from an economic and social perspective on the basis that, by making the promoter of tax schemes at risk of financial loss in the same way that the investor is at risk, then this will deter the marketing of schemes and provide investors with protection from bad investments and therefore encourage more legitimate and productive investments.⁶⁶ The promoter would be required to pay to an amount of money equivalent to the amount of tax, interest and penalties that is required to be paid by the taxpayer as a result of having entered into the scheme in the first place, if the scheme is found to have constituted tax avoidance or tax evasion. The money to be paid by the promoter is in the form of a civil penalty that can be imposed by the Federal Court up to a maximum of \$550,000 for individuals, or \$2.75 million for a body corporate, and twice the consideration received as payment for selling the scheme.

The objective of providing investor protection is a very positive move on the part of the Government but it is also designed to support Part IVA, the tax avoidance measures, because of a perceived weakness in the current provisions. This issue was discussed by McCormack and Anderson on the basis that Part IVA may not extend to promoters of tax schemes in order for them to be penalised under those provisions.⁶⁷ It would be usual for a promoter to obtain a fee or profit from the underlying scheme rather than a tax benefit. The only way to penalise the promoter was to introduce the 'promoter penalty' regime. The ATO have recently released their practice statement, PS LA 2008/8 to provide guidance to their staff as to the application of the law to situations involving the promotion of tax schemes and in particular the role of the 'promoter penalty review panel' that is responsible for administering the law.

B Civil penalties, Promoter and Tax Exploitation Schemes

This area of the law gives rise to most of the perceived problems that may confront accountants, tax lawyers and financial advisers providing taxation advice to their clients. The concept of imposing a 'civil penalty' is similar to the range of remedies available to the Australian Securities and Investment Commission in situations where

⁶⁵ Explanatory Memorandum, Tax Laws Amendment (2005 Measures No 6) Bill 2005, 4.

⁶⁶ *Ibid*, 59.

⁶⁷ McCormack J and Anderson D, Tax Schemes: "Unscrupulous promoters stand warned" (2004) 38 *Taxation in Australia*, 27. The contention in the paper was that in the case of *Vincent v FCT* (2002) 51 ATR 18, the Full Bench of the Federal Court was not prepared to hold that the promoter engaged in the scheme in order to generate a tax benefit but rather to make a profit out of the companies associated with him.

it may be difficult to obtain sufficient evidence to satisfy a burden of proof 'beyond reasonable doubt' (as is the case in criminal proceedings), but it may be possible to satisfy a burden of proof of 'balance of probabilities', under civil proceedings. While it may be good law to impose civil penalties on those involved in insider trading, or breaching directors duties, it may not be the case with taxation law, where there is a reasonable argument that the conduct is within the law and does not amount to tax avoidance. This area of taxation law is still very vague and penalties may be imposed before a court has had an opportunity to rule on the legitimacy of the tax scheme. This situation could arise as it can take many years before a dispute as to whether or not a tax arrangement constitutes tax avoidance or tax evasion is determined by the High Court, but in the meantime the promoter has been required to pay civil penalties.

What is meant by the term 'promoter'? Section 290-60 provides the meaning of *promoter* as:

- (1) An entity is a *promoter* of a tax exploitation scheme if:
 - (a) the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
 - (b) the entity or an associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
 - (c) having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.
- (2) However, an entity is not a *promoter* of a tax exploitation scheme merely because the entity provides advice about the scheme.
- (3) An employee is not to be taken to have had a substantial role in respect of that marketing or encouragement merely because the employee distributes information or material prepared by another entity.

What would be the situation for accountants, tax lawyers and financial advisers in a situation where their clients would like to utilise the services of an OFC in say, Singapore, in order to invest their savings more effectively? Simply locating investments in an OFC such as Singapore⁶⁸ does not amount to tax avoidance or tax evasion and most accountants and taxation advisers would still believe that such an arrangement was legal. If the accountant or tax adviser in Australia provided advice or received a payment from the offshore finance centre does this make them a promoter? Clearly it can be seen that merely giving advice does not make that person or entity a promoter, but what is the situation if they received a commission related to the amount of money invested with the financial institution in Singapore, or encouraged their clients to enter into the arrangement, would they be caught by section 290-60 and possibly face civil penalties?

One major criticism of the promoter penalty provisions contained in Division 290 is that while the Explanatory Memorandum does try to clarify the meaning of 'promoter', section 290-60 fails in its attempt to provide any detailed clarification as to the extent of the conduct required to be held to be a 'promoter'. For example, in the Explanatory Memorandum, the promoter needs to have a 'substantial role' in the promotion of the tax exploitation scheme and not merely provide advice. The concept

⁶⁸ Singapore is regarded by both Australia and the OECD as an offshore financial centre and has demonstrated a reluctance to cooperate on the disclosure of banking information unless it concerns their own tax law. The OECD media release dated 29 September 2008, titled, 'Financial Centres become more transparent, but information exchange remains a problem for some', states that there are 'significant restrictions on access to bank information for tax purposes ... in Singapore.' For more details see the OECD, 'Tax Co-operation: Towards a level playing field' (2006) OECD, 20.

of what is a 'substantial role' is to some extent discussed in the Explanatory Memorandum, but only mentioned once in s 290-60(1)(c), as seen above.⁶⁹ The subsection 290-60(3) merely states that having a 'substantial role' requires more than the 'marketing or encouragement through the distribution of information or material prepared by another entity'. It would have been very helpful if the section had provided greater guidance on this point so that accountants and advisers would be able to gain a greater understanding of their legal position when a client asks them for advice on investing money in, say, Singapore. The *Acts Interpretation Act 1901* (Cth), sections 15AA and 15AB, do provide for the judiciary to interpret provisions of the act by taking into account the objectives and the purpose of the government in enacting the 'promoter penalty regime', and section 15AB also allows the court to take into account extraneous materials such as the explanatory memorandum.

The adviser may not be liable to the civil penalties if it can be shown that the arrangement was not a 'tax exploitation scheme', Section 290-65. In summary, the section provides the following meaning of *tax exploitation scheme*:

A scheme is a *tax exploitation scheme* if:

- (1) the scheme was implemented with the sole or dominant purpose of that entity or another entity obtaining a scheme benefit from the scheme;
- (2) if the scheme has been implemented and it is not reasonably arguable that the scheme benefit is available at law or would be available at law;

This then leads to the question, what is meant by the term 'reasonably arguable'? The statutory provision covering this area of law is found in Schedule 1, s 284-15, of the TAA 53, in relation to the imposition of penalties for a shortfall in the payment of tax. The concept of what constitutes a 'reasonably arguable' position was considered judicially by the Federal Court in *Prebble v Federal Commissioner of Taxation*.⁷⁰

C When is a matter 'reasonably arguable', Section 284-15

Section 284-15 (1) states that 'a matter is 'reasonably arguable' if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.'

Section 284-15 (2) states that to the extent that a matter involves an assumption about the way in which the Commissioner will exercise a discretion, the matter is only 'reasonably arguable' if, had the Commissioner exercised the discretion in the way assumed, a court would be about as likely as not to decide that the exercise of the discretion was in accordance with law.

In *Prebble v Federal Commissioner of Taxation*, the taxpayer, Dr Prebble was denied a deduction for a contribution made to a non-complying superannuation fund. However, even though the deduction had been denied, Cooper J held that as a result of advance opinions and rulings having been issued by the ATO to other taxpayers in earlier years, it was 'reasonably arguable' for him to take that position in preparing his tax return and therefore no understatement penalties should be imposed.⁷¹ It would be very difficult to predict whether this case and the existence of s 284-15 will provide comfort for advisers engaged in encouraging clients to implement a marketed tax mitigation arrangement? It would be comforting for advisers to think that the Federal

⁶⁹ Explanatory Memorandum, n 60, 49.

⁷⁰ (2002) 51 ATR 459.

⁷¹ *Ibid*, 470.

Court would find that they have not contravened Division 290, of the TAA 53, on the basis of a reasonably arguable position. However, with all litigation it is not possible to predict the outcome, and they could be facing civil penalties as a promoter of a tax exploitation scheme.

D No distinction between Tax Evasion and Tax Avoidance: Overseas Experience

It is disappointing that the new law does not differentiate between tax evasion and tax avoidance. The new law simply lumps the two distinct activities into one, namely a 'tax exploitation scheme' and ignores the fact that tax evasion is illegal activity and prosecuted under the criminal law, whereas tax avoidance is legal but may be struck down by the courts under Part IVA. The law does not even consider making a distinction between acceptable tax avoidance and abusive tax avoidance, which appears to be the trend in other countries, as discussed above. The two activities, tax avoidance and tax evasion are clearly different and it illustrates the fact that the government is content to blur the distinction. In the USA, New Zealand and Canada, with their equivalent promoter penalty regimes, the distinction has been considered and given appropriate weight and the penalties imposed on promoters of tax shelter schemes are significantly less than those being considered in Australia.

According to McCormack and Anderson,⁷² Australia is not the first country to introduce a civil penalty regime to deter promoters of tax exploitation schemes. McCormack and Anderson discuss the situation in three countries, Canada, New Zealand, and the USA and the measures that have been introduced to deter the promotion of tax schemes. In New Zealand, the Government introduced measures designed to encourage the use of tax rulings issued by the Inland Revenue Department so that the Government can be alerted to new arrangements, in case the law has to be changed to prevent a loss of revenue. The term 'arrangement' is very broadly defined to include 'any contract, agreement, plan or understanding'.⁷³ The Australian equivalent, a 'tax exploitation scheme', has at its core the requirement that the entity has the 'sole or dominant purpose of obtaining a scheme benefit'. In New Zealand, the law requires the tax arrangement to be offered, sold or promoted to at least 10 or more people in New Zealand before it is considered a scheme that is caught under the statutory provisions.⁷⁴ The penalty that can be imposed is the amount of income tax shortfall from all participants in the arrangement. The New Zealand experience is similar to the Australian situation in that both governments are keen to see tax rulings obtained before tax planning arrangements are widely marketed to taxpayers. However, trying to obtain a private ruling in Australia requires time and money which runs counter to the whole concept of having a tax system based on self-assessment.

In Canada, the law to deter tax schemes was introduced on 29 June 2000 and was designed to catch schemes that 'do not work and result in unwarranted claims for deductions'.⁷⁵ According to McCormack and Anderson, the Canadian approach takes a narrow interpretation of the law so that the principles of 'self-assessment' are not undermined, in that all taxpayers are entitled to prepare their tax returns on the basis that they are correct in assessing their income and deductions, and that their position

⁷² Ibid, 423.

⁷³ Ibid, 425.

⁷⁴ The new measures were made law on 26 March 2003 and are contained in the *Tax Administration Act 1994* (NZ).

⁷⁵ Ibid, 425.

has merit, in the absence of any misleading or criminal conduct.⁷⁶ The penalties in Canada are significantly less than those in Australia, namely the greater of \$1,000 and 100 per cent of the gross revenue gained from selling the tax shelter arrangement.

In the USA, tax shelter promoters are required to register their scheme with the Inland Revenue Service. The penalties are the greater of \$1,000 and 20 per cent of the gross income derived from the arrangement. However, the IRS Internal Revenue Manual, Part 20, states that 'a tax adviser would not be subject to the penalty for suggesting an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty'.⁷⁷

There is genuine concern that some taxation advisers may be caught by the law even when providing advice to their clients on marketed tax mitigation arrangements. There is a fine line between tax planning and tax avoidance, but in both cases there is no criminal conduct on the part of the adviser or taxpayer. It does not appear that the Government considered the experience in Canada and the USA, and in particular the penalty provisions, before enacting the new law.

One of the main concerns with the law is that many innovative lending and financial arrangements may not be promoted simply because the originators of the plans are hesitant to release the products for fear of being subject to very onerous civil penalties. Also of major concern is that the self-assessment system may be severely undermined as a result of taxation advisers being too frightened to be seen as 'promoters of tax exploitation schemes' when preparing their clients' tax returns and offering taxation advice. The Government may well have taken a 'sledge hammer' approach to a perceived problem and dressed it up as investor protection. Consequently it may have caused many taxpayers and accounting and law firms to be too frightened to take a position considered to be well within the law, but may subsequently be regarded as tax avoidance, therefore branding them as unscrupulous tax scheme 'promoters'. In a situation where an accountant or lawyer is asked by their client to provide advice and to use their professional network to establish an investment fund with an offshore bank in, say, Singapore, what should they do? They will not be held to be engaging in the conduct of being a tax scheme promoter if the structure is not marketed to other clients of the firm or other professional practices. However, if that client fails to include any foreign income in their tax return each year, is the tax adviser then held to be a tax scheme promoter and guilty of a criminal offence? The tax adviser would be very wise to have extensive evidence that their client was made aware of their obligations to declare all foreign income and that criminal sanctions could be imposed, similar to those imposed on Glenn Wheatley,⁷⁸ and potentially other taxpayers targeted by 'Operation Wickenby'.

V A FURTHER EXAMPLE OF BLURRING: THE AML/CTF ACT

The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (AML/CTF Act)⁷⁹ was introduced to overcome the inadequacies of the existing law

⁷⁶ Ibid, 426.

⁷⁷ Ibid, 426.

⁷⁸ Glenn Wheatley, a high profile Australian, was sentenced to gaol on 19 July 2007 for tax evasion as a result of using a tax haven to hide his investments. His actions were detected as part of the 'Project Wickenby' investigations. ATO, 'Banking on you, our open door policy', Speech by the Commissioner of Taxation, Australian Bankers' Association Tax Workshop, Sydney, 22 August 2008.

⁷⁹ The AML/CTF Act 2006 received Royal Assent on 12 December 2006.

relating to the reporting of cash transactions and to require professional accounting, legal and financial advisory firms to report suspect transactions. The law has been implemented over a 24 months period to allow businesses to meet their obligations.⁸⁰ The first tranche has 'covered the financial and gambling sectors, bullion dealers and lawyers/accountants, but only to the extent that they provide financial services in direct competition with the financial sector'.⁸¹ The second tranche then applied to real estate agents as well as accountants/lawyers carrying out certain transactions such as setting up a company in a foreign country. This means that accountants and lawyers will, from 12 December 2008, be required to report their clients if engaged in suspicious transactions such as transmitting money to a tax haven or OFC. On the face of it, such conduct would appear to constitute the act of money-laundering because the proceeds of that conduct would constitute the proceeds of a crime, in this case the crime being tax related. Even if the client was engaged in legitimate tax planning activity the transfer of funds to a tax haven would need to be reported to the Australian Transaction Reports and Analysis Centre, (AUSTRAC).

The Replacement Explanatory Memorandum⁸² to the AML/CTF Bill states that the 'reforms are a major step in bringing Australia into line with international best practice to deter money laundering and terrorism financing that includes standards set by the Financial Action Task Force (FATF)',⁸³ and hence the reason for its proposed enactment. Prior to the AML/CTF Act, under the *Financial Transactions Reports Act 1988* (Cth) cash dealers were required to report suspect transactions involving \$10,000 or more in cash or international funds transfers, and the opening of bank accounts in Australia. The statutory law in existence prior to 2006 was not considered by the Government to be adequate, especially with the increase in non face to face transactions through electronic transfers. Instead, the AML/CTF Act adopts a 'risk based approach' to identifying customers that may be engaged in money laundering or terrorism financing and applies to a very wide range of businesses, not just cash dealers. The use of tax havens and schemes devised by lawyers and accountants is now part of the focus of the new law and will be comprehensively dealt with in the second tranche of law.

A What is 'money laundering'?

Much is made of the conduct known as 'money laundering', but very little attention is paid to defining exactly what are the essential ingredients in the act of engaging in 'money laundering'. In the 'Issues Paper 1, Financial Services Sector' released as part of the Commonwealth Attorney-General's Department paper on the Anti-Money Laundering Reform, an attempt was made to describe 'What is money laundering?'⁸⁴ 'The goal of most criminals is to generate a profit. To enjoy their ill-gotten gains, criminals commonly seek to disguise the illegal source of those profits. Money laundering is the processing of criminal profits to disguise their illegal origin.'

⁸⁰ The obligations under the Act require (1) customer identification and verification within 12 months from 12 December 2006; (2) record keeping – in various stages within the 12 months; (3) establishing and maintaining an AML/CTF program – within 12 months; (4) ongoing customer due diligence and reporting suspicious matters, international funds transfers – 24 months after 12 December 2006.

⁸¹ Replacement Explanatory Memorandum to the AML/CTF Bill at page 1.

⁸² The new law was released to the public for comment as an 'exposure draft' and the Anti-Money Laundering and Counter Terrorist Financing Bill was eventually introduced to the Commonwealth Parliament on 1 November 2006 after taking into account submissions by interested parties.

⁸³ Replacement Explanatory Memorandum, n 30, 1.

⁸⁴ Issues Paper 1, Financial Services Sector, 1.

In the Australian Law Reform Commission Report 87⁸⁵ on the Proceeds of Crime and in particular Part 7, Laundering of Property and Money, the report attempts to define money laundering as follows:

The definitions of money laundering most frequently used in domestic legislative provisions is derived from that used in the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances⁸⁶ which provides that money laundering is:

- the conversion or transfer of property, knowing that such property is derived from any indictable offence or offences, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person, who is involved in the commission of such an offence or offences to evade the legal consequences of his or her actions or
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from an indictable offence or offences or from an act of participation in such an offence or offences.⁸⁷

Similarly, in the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, money laundering is defined as follows

a. the conversion or transfer of property, knowing that such property is proceeds, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of the predicate offence to evade the legal consequences of his actions;

b. the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is proceeds.⁸⁸

This means that tax evasion, which constitutes the criminal offence of 'defrauding the Commonwealth', which is in the Commonwealth Criminal Code,⁸⁹ could amount to money laundering if an OFC or a tax haven was used to disguise or conceal income from investments that were not subsequently declared in the Australian taxpayers tax return. The offence of money laundering is contained in Part 10.2, Division 400 of the Criminal Code. The Replacement Explanatory Memorandum to the AML/CTF Bill provides the following estimate of the extent the financial problem faced by the Government in terms of money that is being laundered every year and not being subject to income tax in Australia.

The size of the money laundering problem cannot be accurately quantified but, in a research project funded by AUSTRAC and drawing on a wide range of financial and other data relating to 1994, it was estimated that in that year `a range of between \$1, 000 million and \$4,500 million would appear to be a sensible interpretation of the information provided in these sets of estimates, with perhaps some confidence that the most likely figure is around \$3,500 million, since this figure lies within all three estimate ranges.⁹⁰

⁸⁵ ALRC Report 87: Proceeds of crime, <www.alrc.gov.au> 2 January 2007.

⁸⁶ Although that was restricted to narcotics related offences.

⁸⁷ Australian Treaty Series 1993 No 4 UNTS art 3(1)(b).

⁸⁸ ETS No 141 art 6.

⁸⁹ The offence of defrauding the Commonwealth was until 2005 contained in the Crimes Act 1914 (Cth), s 29D.

⁹⁰ J Walker *Estimates Of The Extent of Money Laundering In And Through Australia* AUSTRAC September 1995, 39. This report is also referred to in the Replacement Explanatory Memorandum to the AML/CTF Bill at page 12 to justify the introduction of the law.

B *Designated services – Lawyers, accountants and financial advisers*

The concept of requiring businesses engaged in providing ‘designated services’ to report suspect customers and obtaining proof of identification are the key measures being used by the law to detect suspicious matters. The definition of ‘designated services’ is so broad, that it will cover all businesses which provide trade credit, including all consumer credit transactions. There is also no limit on the money being paid for a designated service, except a \$1000 limit for stored value cards.

The Act generally requires a business to ‘identify’ new customers before providing a service. Circumstances in which a customer can be identified after the service has been provided are if the prior identification would disrupt the ordinary course of business, the service is specified in the AML/CFT Rules, and:

- It is not provided face-to-face; or
- It consists of acquiring or disposing of a security or derivative on behalf of a customer; or
- It consists of issuing or undertaking liability as the insurer under a life policy or a sinking fund policy.
- In some circumstances, the provision of certain low-risk services will not require client identification.

The AML/CTF Rules are made by AUSTRAC pursuant to powers provided by s 229 of the AML/CTF Act and to date a number of rules have been made.⁹¹

Lawyers, accountants and financial advisers are only under an obligation to report suspicious matters when providing ‘designated services’. Section 6 of the Act contains two tables. The first lists 63 designated services of a financial services nature with specific reference to Australian Financial Services License holders (Items 62 and 63 refer to buying and selling bullion). The second table refers to gambling services. Therefore lawyers, accountants and financial advisers are a reporting entity to the extent that they provide designated services.

For example, lawyers acquiring or disposing of securities on behalf of clients, creating and dealing with promissory notes, bills of exchange, and arranging safe deposit box facilities are providing a designated service. Preparing a will is not a designated service. However, the purchase of real property and the provision of mortgage finance or international transfer of funds is a designated service because the transfer of real property and mortgage arrangements can be used to launder money.⁹² Similarly, the creation of a trust or company structure to be used to move funds offshore or on shore will be a designated service. The following services are not regarded as being ‘designated services’:

- Preparation of a tax return is not a designated service.
- Providing advice on what are securities and derivatives.
- Establishing a superannuation fund and then advising on the investment of the funds.
- Advising on life insurance or a sinking fund insurance policy.

⁹¹For more details see AUSTRAC, www.austrac.gov.au/aml_ctf_rules.html, accessed 21 November 2008

⁹² AML/CTF Bill, Issues Paper 5 – Legal Practitioners – Accountants – Company and Trust Service Providers, 5.

The main thrust of the AML/CTF Act is to require businesses which provide designated financial services to have a process to identify their customers. Professional advisers are referred to as 'gatekeepers' in the Explanatory Memorandum because of those people involved in money laundering using the services of professionals to launder the money. The Government has recognised that criminals use sophisticated structures such as trusts, companies and managed investment schemes to launder money. However, what happens when an existing client seeks advice from their lawyer or accountant about establishing an investment fund in say, Singapore, because they want to diversify their investments. Would their accountant or lawyer have to report this activity or be in breach of their obligations under the AML/CTF compliance requirements, or do they make the judgment that the activity is legal and does not amount to money laundering? The simple answer is that they must report those transactions to AUSTRAC or face serious consequences.

The AML/CTF Act requires professional practices, whether they are engaged in accounting, legal or financial planning services, to not only formally identify their clients but also to report their activities to AUSTRAC that may be suspicious in terms of money laundering or terrorist financing. As was mentioned above, the government is aware that these types of professional practices provide services to those people engaged in money laundering and they want to identify those involved so that they can be prosecuted. Unfortunately, taxpayers engaged in tax planning activities may be caught by this new law as it makes no distinction between tax evasion, tax avoidance or tax planning. Clearly, the government would like to see all tax minimisation activity categorised as constituting a criminal offence and then the taxpayer can be prosecuted under the Commonwealth Criminal Code for money laundering.

C International implications of the Law

Designated services are not subject to the new law unless the service is provided in Australia through a 'permanent establishment' of a Foreign Service provider, or the service is provided by an Australian resident or a resident subsidiary company through a permanent establishment in a foreign country. Will this law result in Australians obtaining financial and taxation advice from a non-Australian provider in a location outside Australia? This may well be the case and the government will be in an even more difficult situation in trying to detect Australian taxpayers engaged in tax planning activities in tax havens and OFCs. Similarly, will Australians be reluctant to obtain tax planning advice in Australia even if not engaged in money laundering, but legal tax mitigation using a tax haven or OFC? In particular, what effect will this law have on Australians using tax havens for legal purposes? Given that Australian Banks, Australian accounting firms and Australian law firms have offices in tax havens in the Asia-Pacific region their services are subject to the AML/CTF Act where they are operating through a permanent establishment in that country. These questions will not be answered for a number of years and should provide a fertile area for future research. Indeed, as Eden and Kudrle noted regarding the future of tax havens in light of initiatives by the OECD and now Australia, with the proposed anti-money laundering legislation, at this stage no research has been undertaken into the role of the multinational enterprises and international tax and accounting firms located in tax havens.⁹³

⁹³ Lorraine Eden and Robert Kudrle, n 52, 124.

VI IMPLICATIONS FOR THE 'RULE OF LAW'

One of the major implications of the government treating all tax minimisation activity, either by tax avoidance or tax evasion, as constituting criminal activity, is that it threatens the 'rule of law'. By ignoring clear distinctions within the established taxation law of Australia on this point, it provides the ATO with powers that potentially infringe the rights of taxpayers. More importantly, by confusing the issue of what constitutes acceptable tax mitigation activity with unacceptable tax avoidance, the rule of law is put at risk by the inherent complexity of the current law.

The 'Rule of Law' is a principle contained in the English legal system and as enunciated by Professor Dicey, holds that all men are equal under the law except the Crown.⁹⁴ It can also be expressed as the notion 'that the people and the government should obey the law and be ruled by it', but the legal concept of the 'rule of law' is not readily definable.⁹⁵ What is important in this context is the fact that there is a 'strong correlation between economic growth and a strong rule of law...'⁹⁶ In other words; a country that ensures that all of its citizens and the government obey the law will have a strong and vibrant economy. If that is the case then the law must be easy to understand and administered fairly, and the doctrine of separation of powers should also operate effectively. Parliament, consisting of elected representatives, makes the law; the Executive administers the law and the Judiciary resolves any disputes arising from interpreting the law. In the context of a deliberate blurring of the distinction between tax avoidance and tax evasion, the rule of law has relevance because of how the existing law is to be made and interpreted by Parliament, the Executive and administrators, and the Judiciary. Professor Walker is of the opinion that the rule of law is being eroded due to the number of wide discretions, especially in relation to tax avoidance, Part IVA, and provides the following statement to that effect:

The ultimate grant of discretionary power is, of course, Part IVA, enacted in 1981 and to which the rest of the Act is subject. Australia has placed more reliance on the GAAR than any other Western democracy, and Part IVA's supporters argue that it may strengthen the rule of law by increasing compliance with tax legislation. The problem, however, is that it seeks to encourage compliance by means that compromise the rule of law, for example by depending on discretion and opinion.⁹⁷

Professor Walker contends that there is far too much discretion given to both the ATO and the courts in determining what constitutes tax avoidance. He quotes extensively from Professor Jeffrey Waincymer in that 'this approach offends against the separation of powers doctrine and the requirement that the laws be made by parliament not bureaucrats'.⁹⁸

One of the key issues that Professor Walker has identified as being conducive to an erosion of the rule of law is found in the ATO's ruling system where in 'perhaps 90 percent of cases these materials are consistent with enacted law, but in the remainder

⁹⁴ Woodley, Mick (ed), *Osborn's Concise Law Dictionary* (10th ed, 2005) 359.

⁹⁵ Buckley, Ross, (ed) *Overseas Law, The Rule of Law and Economic Vibrancy* (2003) 77 *Australian Law Journal* 424, 424.

⁹⁶ *Ibid*, 425. Ross Buckley has taken this quote from Douglas North, the Nobel Prize winner in Economics in 1993 who researched the correlation between the rule of law and economic growth and development.

⁹⁷ Walker, Geoffrey de Q, 'The Tax Wilderness – How to Restore the Rule of Law' (2004) CIS Policy Monograph 60, *The Centre for Independent Studies*, 3.

⁹⁸ *Ibid*, 3. The reference to Professor Waincymer is taken from Waincymer, Jeffrey, 'The Australian Tax Avoidance Experience and Responses: A Critical Review', in Cooper, *Tax Avoidance and the Rule of Law*, 247.

the ATO is effectively making its own rules'.⁹⁹ In 1992, when the ruling system was being introduced into Parliament by the Minister assisting the Treasurer, it was stated that 'the ruling system was touted as promoting certainty for taxpayers and thereby reduce their risk and opportunity cost'.¹⁰⁰ However, a recent example of where an ATO ruling, TR 1999/5 was in conflict with the case law is found in the Federal Court decision in *Essenbourne Pty Ltd v FCT*.¹⁰¹ The ruling was subsequently withdrawn on 27 June 2007 after the Commissioner of Taxation had publicly disagreed with the decision of Kiefel J through an ATO Media release¹⁰² and the Commissioner had brought three more cases before the Federal Court in an attempt to obtain a Federal Court decision in line with its public ruling, TR 1999/5. In the end, all of the Federal Court decisions¹⁰³ held that there was no fringe benefit in the situation involving employee benefit trusts and non-complying superannuation funds. The major issue threatening the 'rule of law' in this situation was that the Commissioner of Taxation was adopting the position of the Parliament and the Judiciary in making new taxation law in relation to the fringe benefits tax. The stance taken by the ATO went far beyond what is required to administer the taxation law and would have added to the confusion facing tax professionals, business and individual taxpayers.

Professor Walker provides a number of examples of situations where the discretion provided to the Commissioner of Taxation has led to the ATO adopting the role of law maker and as such threatening the rule of law.¹⁰⁴ One example that has serious implications for tax administration is the bonus arrangement that auditors are being paid for every extra dollar of revenue collected. As Professor Walker states, 'the practice of remunerating tax officers according to the amount of revenue they collect recalls the 18th century tax-farming abuses that helped trigger the French Revolution'.¹⁰⁵

V CONCLUSION

The distinction between tax avoidance and tax evasion, that has been firmly established in the Australian common law, is still of great importance when dealing with taxation issues domestically. However, it would appear that the Australian Government is determined to ignore the distinction between tax avoidance, a legal activity and tax evasion, a criminal activity, when it comes to Australian taxpayers engaging in tax planning in a tax haven or through the use of an OFC. The Government has recognised that many tax schemes involve the use of tax havens, and appear to have designed a set of laws to deter the promotion of tax schemes that make no distinction between tax avoidance and tax evasion. Similarly, in relation to the law to detect and eliminate money laundering, once again the Government appears to have deliberately blurred the difference between tax avoidance and tax evasion. The AML/CTF Act would appear to designate that all measures to reduce and minimise income tax through the use of tax havens constitutes criminal activity and therefore

⁹⁹ *Ibid*, 2.

¹⁰⁰ Wallis, David, 'The tax complexity crisis' (2006) 35 *Australian Tax Review* 274, 283.

¹⁰¹ (2002) 51 ATR 629.

¹⁰² Australian Taxation Office, Media Release National 03/30 (2003).

¹⁰³ The cases before the Federal Court that held that there was no fringe benefit in terms of the ruling TR 1999/5 were *Walstern Pty Ltd v FCT* (2003) 138 FCR 1, *Caelli Constructions (Vic) Pty Ltd v FCT* (2005) 147 FCR 449, and *Indooroopilly Children Services (Qld) Pty Ltd v FCT* [2007] FCAFC 16.

¹⁰⁴ Walker, Geoffrey, n 96, 3-5.

¹⁰⁵ *Ibid*, 5.

justifies the tax haven in breaching its bank secrecy laws. The fact that the rights of the taxpayer may be adversely affected and the taxpayer wrongly being accused of criminal activity is of no concern for the Government when trying to maximise government revenue.

TAX POLICY AND GLOBALISATION: A COMPARATIVE CASE STUDY OF RETIREMENT SAVINGS TAXATION

LISA MARRIOTT*

Economic growth and population ageing have been important influences on social policy spending since the mid 1960s.¹ However, over the past 25 years the potential impact of a third influential factor has been introduced: globalisation. While economic factors remain highly relevant, questions are being raised about the role of globalisation in social policy.

A number of theories exist on the impact of globalisation on social policy. Two theories are most frequently debated; firstly, that globalisation limits the ability of the state to control social policy and secondly, that globalisation is not the cause of the perceived 'welfare state crisis' and factors such as cultural perspectives and ideologies create resistance to the path of globalisation in social policy.

The paper investigates the influence of globalisation on tax policy, using the taxation of retirement savings in Australia and New Zealand as a comparative case study. Over the past two decades Australia and New Zealand have adopted vastly different policy solutions to the 'problem' of population ageing; Australia with generous tax concessions and compulsory occupational superannuation, New Zealand with a small tax incentive and a universal state pension. These different approaches are analysed within the framework of the globalisation literature.

I INTRODUCTION

Economic growth and population ageing have been important influences on social policy spending since the mid 1960s.² However, over the past 25 years the potential impact of a third influential factor has been introduced: globalisation. While economic factors remain highly relevant, questions are being raised about the role of globalisation in social policy.

Typically, globalisation is described as the reduction of geographical boundaries to encourage free trade flows. Tax policy is not immune to the influence of globalisation, and tax reforms since the 1980s bear witness to this with the adoption of broader base, lower rate tax systems throughout the Organisation for Economic Co-operation and Development (OECD).

As spending on the aged, in the form of superannuation and other provisions, typically accounts for over a third of welfare state budgets among most OECD countries,³ it may be expected that such significant expenditures may be pursued for rationalisation to assist in maintenance, or improvement, of a country's competitive advantage in the global arena. This paper investigates the influence of globalisation

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¹ Francis G Castles, 'Social Expenditure in the 1990s: data and determinants' (2005) 33 *Policy and Politics* 412.

² Ibid.

³ Above n1, 422.

on tax policy, using the taxation of retirement savings in Australia and New Zealand as a comparative case study.

The paper starts with an introduction to tax policy and globalisation. This is followed by a brief review of the literature associated with globalisation, with a focus on research linking globalisation with tax or social policy. The paper then provides a history of the evolution of retirement savings taxation policy in Australia and New Zealand. This is followed by analysis of the extent to which international direction influenced the policy adopted in each country. Data for the analysis was collected from primary source documents, including archival documents, newspaper commentary and submissions to Task Forces, Consultative Committees and Senate Select Committees, together with interviews undertaken with individuals in both countries who were involved in the policy making process from the mid 1980s.

Australia and New Zealand adopted different approaches to retirement savings than many OECD countries. Australia was among the first country to fully adopt a compulsory occupational scheme and has also provided generous retirement savings tax concessions for a number of years. However, until recently Australia has been unique in taxing superannuation at all three stages; contributions, fund earnings and withdrawal.⁴ New Zealand does not have a mandatory occupational superannuation scheme and has only recently reintroduced a small tax incentive after a 20-year absence of such a concession. The research sets out to offer a potential explanation for these different approaches, within the context of a global environment.

II TAXATION POLICY

From a taxation perspective, most income tax systems in OECD countries give preferential treatment to pensions. Such preferential treatment may take the form of tax relief on a portion of, or all, pension income received, or the taxation system may privilege those receiving pensions in the form of additional allowances or zero-rate personal income tax bands. In addition, tax concessions generally exist to encourage individuals to save for their retirement.

The levels of taxation applied at various stages distinguish different taxation arrangements. Typically these are referred to in the order of contributions, investment earnings and withdrawals: T refers to fully taxed; E is tax exempt; and t refers to concessionary taxation. The system of taxation in New Zealand for retirement income savings is 'tTE' referring to a tax concession at the contribution point, taxed investment income and exempt benefits.⁵ This scheme was introduced in 2007. From 1988 to 2007 New Zealand's scheme was TTE, which provided no preferential tax treatment for retirement savings. No other OECD country has adopted a TTE system.

The Australian model is 'ttE' as contributions and investment earnings are taxed, but at preferential rates to other forms of savings. Withdrawals from taxed funds by individuals aged over 60 years are tax exempt. These arrangements were implemented in July 2007.

III GLOBALISATION

Typically, globalisation is framed as the "internationalization of production, capital flows and markets, the emergence of trans-national and supra-national agencies and

⁴ These were all taxed at concessional rates.

⁵ A small tax incentive was introduced in April 2008 in conjunction with the KiwiSaver scheme.

the internationalization of culture. The changes are economic, political and social”.⁶ The concept of globalisation has been driven by economic forces including increased labour mobility, reductions in trade barriers and deregulation of financial markets. Globalisation is not limited to influencing macro-level functions, it may also be responsible for the transmission of ideas; for example, McClelland and St John suggest that globalisation may be credited for the adoption of neo-liberal economic policies in both Australia and New Zealand in the 1980s.⁷

A Strong Globalisation Theory

Research is divided on the impact of globalisation on social policy. One of the key arguments from the globalisation literature is that as it becomes easier for businesses, individuals and capital to locate to the most tax advantageous jurisdiction, governments will be under increasing pressure to reduce tax rates to ensure their attractiveness to future investors. The associated suggestion is that in an environment of reducing taxes due to this increased tax competition, social welfare spending would inevitably reduce. Historically, this perspective (known in the literature as the ‘strong globalisation theory’ or the ‘convergence theory’, as policies become more alike) has been among the most frequently debated. The strong globalisation theory suggests that globalisation undermines welfare states, diminishes the ability of the national state to control social policy and creates a ‘marketised’ welfare state.⁸ This is a contentious claim, resulting in considerable academic debate.

A supporter of the strong globalisation perspective is Deacon, who suggests that globalisation creates a challenge to the provision of welfare and “to the prospects for equitable social development in developing and transition economies”.⁹ Deacon suggests that this problem arises as the global environment limits alternative options and also highlights the role that global organisations (such as the World Bank) play in shaping global social policy. This issue is discussed in greater detail later in this section.

Mishra has been a frequent commentator supporting the strong globalisation theory.¹⁰ Mishra argues that globalisation has created significant constraints on the autonomy of the state in social policy formation.¹¹ Furthermore, Mishra claims that political and ideological pressures stemming from globalisation have “impinged significantly on labour markets, taxation, social spending and systems of social protection”.¹²

The strong globalisation theory has been frequently challenged, particularly among more recent research. Among other criticisms, it has been called “wildly overstated,

⁶ Paul Wilding, ‘Globalization, Regionalism and Social Policy’ (1997) 31 *Social Policy & Administration* 411.

⁷ Alison McClelland and Susan St John, ‘Social Policy Responses to Globalisation in Australia and New Zealand, 1980 – 2005’ (2006) 41 *Australian Journal of Political Science* 177.

⁸ Virpi Timonen, *Restructuring the Welfare State: Globalization and Social Policy Reform in Finland and Sweden*, 2003, 40; and Nicola Yeates, ‘Social Politics and Policy in an Era of Globalization: Critical reflections’ (1999) 33 *Social Policy & Administration* 372.

⁹ Bob Deacon, ‘Globalization and Social Policy: The threat to equitable welfare’ (Occasional Paper No 5, United Nations Research Institute for Social Development, Geneva 2000) vii.

¹⁰ For example, Ramesh Mishra, ‘Beyond the Nation State: Social Policy in an Age of Globalization’ (1998) 32 *Social Policy & Administration* 481; and Ramesh Mishra, *Globalization and the Welfare State*, 1999.

¹¹ Ramesh Mishra, ‘Beyond the Nation State: Social Policy in an Age of Globalization’ (1998) 32 *Social Policy & Administration* 481.

¹² Ramesh Mishra, *Globalization and the Welfare State*, 1999, ix.

speculative and ahistorical, which is problematic in terms of its validity, accuracy and the degree of generalization from short-term, cyclical or local changes involved”.¹³ In many cases increased globalisation has resulted in welfare state expansion, rather than the suggested retrenchment suggested by those following the strong globalisation theory.¹⁴ However, many developed welfare states have experienced, to a greater or lesser extent, a degree of benefit reduction since the 1970s, although total welfare expenditure has not always declined.¹⁵

The International Monetary Fund argues that globalisation does not reduce national sovereignty; instead it creates “a strong incentive for governments to pursue sound economic policies”.¹⁶ In support of this view, it is suggested that there are political choices available within the context of globalisation; reduction of spending and services is not the only option. An alternative is to increase spending on some areas of social welfare provision to increase productivity and attract investment.

A frequently raised argument on the impact of globalisation on taxation is that it moves taxation from mobile factors (such as labour) towards less mobile factors (such as consumption), which then has the potential to reduce the tax intake and leads to the aforementioned problem of restricted funding for welfare expenditure. However, research is now also challenging this suggestion; for example, empirical analysis of the majority of OECD countries during both the pre-globalisation period (1946-80) and the globalisation period (1980-2000) by Navarro, Schmitt and Astudillo finds, contrary to predictions, that capital taxes have increased and labour taxes have decreased in the majority of OECD countries.¹⁷ There is no argument that tax rates have decreased in most OECD countries over the period of globalisation.¹⁸ However, this has not resulted in decreases in tax revenue, instead leading to greater changes in the tax mix, such as increases in indirect taxation. As observed by Hines, taxes on internationally mobile activity represent only a small fraction of total revenue collection, whereas personal income taxes, consumptions taxes and, in some countries, social security contributions, make the greatest input towards financing welfare expenditure.¹⁹

¹³ Nicola Yeates, ‘Social Politics and Policy in an Era of Globalization: Critical reflections’ (1999) 33 *Social Policy & Administration* 375.

¹⁴ Martin Rhodes, ‘Globalization and West European Welfare States: A critical review of recent debates’ (1996) 6 *Journal of European Social Policy* 307.

¹⁵ Duane Swank, ‘Withering Welfare? Globalisation, political economic institutions, and contemporary welfare states’ in L Weiss (ed) *States in the Global Economy: Bringing domestic institutions back in*, 2003, 69 and Linda Weiss, ‘Is the State being “Transformed” By Globalisation’ in L Weiss (ed) *States in the Global Economy: Bringing domestic institutions back in*, 2003, 295.

¹⁶ International Monetary Fund. *Globalization: Threat or Opportunity?* 2000, 9.

¹⁷ Vicente Navarro, John Schmitt and Javier Astudillo, ‘Is Globalisation Undermining the Welfare State?’ (2004) 28 *Cambridge Journal of Economics* 151.

¹⁸ See, for example, discussion in Steffen Mau, 2004, *Globalisation and the Political Visibility of the Welfare State*, Paper prepared for the Second Annual ESPANET Conference, Oxford, 9-11 September 2004; or Steffen Ganghof and Richard Eccleston, ‘Globalisation and the Dilemmas of Income Taxation in Australia’ (2004) 39 *Australian Journal of Political Science* 519.

¹⁹ James R Hines, ‘Will Social Welfare Expenditures Survive Tax Competition?’ (2006) 22 *Oxford Review of Economic Policy* 331. Hines suggests that corporate taxes made up around 10 – 15 per cent of total revenue collections in the 30 wealthiest OECD countries between 1972 and 2004.

B 'Weak' Globalisation Theory

A second argument within the globalisation literature is that while there may be a perceived welfare state crisis,²⁰ globalisation is not the cause.²¹ Genschel suggests that "there is neither theoretical reason nor empirical evidence to believe that national policy autonomy has decreased owing to increasing economic interdependencies".²² Genschel's research, along with the majority of more recent studies and unlike some research undertaken earlier in the 'globalisation period', finds little relationship between globalisation and social spending or national economic policy among OECD countries.²³ Instead, many researchers find expansion of social public expenditures during the generally accepted globalisation period of 1980-2000.²⁴

C The Middle-Ground Approach

A third perspective is proposed by Hobson.²⁵ Hobson calls for a 'middle-ground' approach to the politics of globalisation, arguing that the debate is limited by "its 'either/or' framework: either globalisation is all-powerful and states are impotent; or globalisation is weak and states are dominant".²⁶ Arguing against the strong globalisation 'race to the bottom', and the mainstream conventional arguments (including the suggestion that increasing capital mobility results in reduced taxes and welfare spending), Hobson tests this, and other, propositions by analysing the evolution of tax policy across 23 OECD countries. Hobson finds that aggregate tax revenue burdens trend upwards in the period from 1965 onwards, thus claiming that "it is premature, if not facile, to assume that globalisation signifies the end of the state, or even the 'retreat of the state' and concludes that globalisation both 'constrains and enables states in their fiscal policymaking'".²⁷

It has also been suggested that local influences, including cultural impacts, ideologies and interest groups may create resistance to the path of globalisation in social welfare policy.²⁸ A key argument within this view is that increased international competition raises societal demands for increased welfare protection, thereby limiting the ability of the state to cut welfare spending.

Not surprisingly, there is no agreement among the various schools of thought as to which theory should take precedence. Much research has investigated this topic, and researchers observe that both quantitative and case study research have produced such

²⁰ Rhodes suggests that the idea of a 'crisis' in the welfare state has existed since the early 1970s. Rhodes claims that "whether this amounts to a 'crisis', an 'impasse' or just a difficult conjuncture is a fiercely debated – and politicized – subject". Above n 14, 306-307.

²¹ Philip Genschel, 'Globalization and the Welfare State: A retrospective' (2004) 11 *Journal of European Public Policy* 613.

²² *Ibid.*

²³ For example, Axel Dreher, 'The Influence of Globalization on Taxes and Social Policy: An empirical analysis for OECD countries' (2006) 22 *European Journal of Political Economy* 179; Axel Dreher, Jan-Egbert Sturm and Heinrich Ursprung, 'The Impact of Globalization on the Composition of Government Expenditures: Evidence from panel data' (2008) 134 *Public Choice* 263; or Steffen Mau, *Globalisation and the Political Visibility of the Welfare State*, Paper prepared for the Second Annual ESPANET Conference, Oxford, 9-11 September 2004.

²⁴ Above n17.

²⁵ John M Hobson, 'Disappearing taxes or the 'race to the middle'? Fiscal policy in the OECD' in L Weiss (ed) *States in the Global Economy: Bringing domestic institutions back in*, 2003.

²⁶ *Ibid* 38.

²⁷ Above n25, 56.

²⁸ Above n14, 375.

varying results as globalisation can reduce public spending, globalisation can raise public spending and globalisation can have no discernable effect on public spending.²⁹

An example of such research is undertaken by Ferrera, Hemerijck and Rhodes who review the globalisation arguments.³⁰ They find that there is some evidence of external influence on policy makers, but that it is a combination of other economic factors, such as national debt and spending and domestic tax resistance that play the most significant role in constraining social welfare spending in some countries. Ferrera, Hemerijck and Rhodes write:

Nation states are not like markets – easily overrun by economic forces, global or otherwise. Rather they are communities of fate. Policy changes have to be endorsed by elected governments and parliament and must continue to be mediated by national political parties, bureaucracies, and systems of interest intermediation.³¹

Thus, the authors suggest that globalisation is much less influential than frequently acknowledged.

Timonen also argues that globalisation theories tend to assume that there is no choice at a national level.³² However, Timonen suggests that when investigating cases of retrenchment policies, it can be found that politicians are reluctant to change popular policies and interest groups are frequently capable of influencing policy through the protest mechanism or the voting option. As Timonen notes “politics, in other words, has not been dwarfed by the markets”.³³

D Globalisation And Tax Reform

Researchers suggest globalisation will result in greater inter-dependency in tax systems as geographical mobility increases and individuals become more sensitive to marginal tax rates.³⁴ Considerable reform has taken place in OECD country tax policies over the past two decades. Steinmo claims that in the ten years between 1984 and 1994, every OECD country either made or suggested major tax system restructuring.³⁵ Typically these reforms include broadening the tax base, reducing the tax rates and a greater focus on consumption taxes. A common theme among the reforms has been increased efficiency and greater neutrality among the tax systems. A further trend has been to curtail tax incentives in some areas.

Steinmo suggests that globalisation is playing a key role in the restructuring of tax systems in industrial democracies and this restructuring will have a significant impact on the future of the welfare state.³⁶ The arguments supporting this proposal start with the increased mobility of capital, leading to pressure to reduce both the burden of tax on capital, but also on the wider economy. Steinmo then argues that with reduced tax

²⁹ For example, Francis G Castles, ‘Social Expenditure in the 1990s: data and determinants’ (2005) 33 *Policy and Politics* 413 and Philip Genschel, ‘Globalization and the Welfare State: A retrospective’ (2004) 11 *Journal of European Public Policy* 613.

³⁰ M Ferrera, A Hemerijck and M Rhodes, ‘The Future of the European “Social Model” in the Global Economy’ (2001) 39 *Journal of Comparative Policy Analysis* 163.

³¹ *Ibid* 164.

³² Virpi Timonen, *Restructuring the Welfare State: Globalization and Social Policy Reform in Finland and Sweden*, 2003, 47.

³³ *Ibid*.

³⁴ For example, Jeffrey Owens, ‘Globalisation: The implications for tax policies’ (1993) 14 *Fiscal Studies* 21.

³⁵ Sven Steinmo, ‘The End of Redistribution? International pressures and domestic tax policy choices’ (1994) 37 *Challenge* 9.

³⁶ *Ibid*.

revenues, it becomes necessary to reduce public spending. Steinmo notes the potential for a negative by-product from globalisation, impacting on the “ability for governments to intervene in their domestic economies, to affect the distribution of wealth and income in society and, ultimately, to raise revenues for the modern welfare state”.³⁷

In much of the literature a link is made between the adoption of neo-liberal policies, and globalisation and the welfare state. A key argument is that global adoption of neo-liberal policy results in an environment necessitating “systematic welfare retrenchment”.³⁸ Wilding argues that neo-liberalism is the dominant ideology of the global economy, writing: “neo-liberalism is a force for, and ideally requires, globalization”.³⁹ The neo-liberal ideology is associated with a reduction of taxation rates, reduction of the financial burden of the welfare state and reduction of collectivist values. As noted by Yeates:

neo-liberal ideology emphasizes the limited influence and effect that governments can exert over national economic performance or in subverting the ‘natural’ outcomes of global markets, while stressing the costs of certain courses of political action; economic success (and prosperity) or failure (and hardship) in an interdependent and competitive global economy is seen as depending on maintaining a competitive advantage.⁴⁰

Stryker suggests that under a neo-liberal philosophy, a generous redistributive welfare state must be foregone for a national economy to remain competitive.⁴¹

Mishra suggests New Zealand (along with the United Kingdom and the United States of America) is at the forefront of countries where:

globalization and strong neoliberal tendencies in policy-making have come together to erode social citizenship and to weaken, if not repudiate, the earlier commitment to a social minimum as of right. Labour market restructuring, deregulation and taxation policies have combined to create substantial inequalities of income and wealth distribution.⁴²

E The Organisational Role In Globalisation

Generally, different global trade and economic organisations impart different constraints on the policy direction of countries. For example, the OECD, the International Monetary Fund (IMF) and the World Bank are influential in the area of economic and social policy. In some countries these organisations impact on macroeconomic policy, trade, development and investment. Other organisations, such as the United Nations or the International Labour Organisation are more influential in the area of humanitarian concerns, rather than economic issues. A further group of organisations including the World Trade Organisation combine an interest in both humanitarian and economic policy. Influence from these organisations comes in different forms. Mishra suggests that:

by adding to the pressures emanating from financial and capital markets, these global institutions insulate national governments further from the demands of their electorate for social protection. Yet these

³⁷ Above n35, 10.

³⁸ Robin Stryker, ‘Globalization and the Welfare State’ (1998) 18 *The International Journal of Sociology and Social Policy* 10.

³⁹ Above n7, 412.

⁴⁰ Above n14, 379.

⁴¹ Above n39, 9.

⁴² Above n13, 51.

[Intergovernmental Organisations] are not directly representative of or accountable to any elected authority.⁴³

Mishra suggests New Zealand provides a good example of the role that the OECD and the IMF play in promoting deregulation and privatisation.⁴⁴ Mishra argues that the New Zealand reforms in the mid and late 1980s were of the variety favoured by the OECD and the IMF, and that New Zealand become a “test case for implementing neoliberal market reforms”.⁴⁵ The commentary from the OECD on the New Zealand reforms was supportive and the often repeated phrase of changing New Zealand’s tax system into ‘one of the least distorting in the OECD’ is frequently reiterated.

F The European Experience

Much of the research on globalisation and social welfare policy has been undertaken in a European context. Steinmo uses policy developments in Sweden to test whether increased international mobility of capital and labour has resulted in reduced taxes and an associated reduction of welfare state provision.⁴⁶ Sweden had the world’s heaviest tax burden and the largest social welfare state, and while some significant changes had occurred in the welfare state, Steinmo finds that “the tax and spending regimes have been changed less than the globalization thesis predicts”.⁴⁷ Steinmo finds that while Sweden had adapted policies in relation to social welfare, there was little support for the suggestion that either the high-tax or generous social welfare system was not sustainable.

Research undertaken by Timonen investigates the impact of globalisation on institutional welfare states in Finland and Sweden.⁴⁸ Timonen notes that when Finland and Sweden joined the European Union in 1995, questions were raised about the potential for generous welfare states to remain in the presence of increasing global competition. The argument raised is that “the high taxes necessitated by generous and extensive welfare programmes and services would weaken work incentives and make Finnish and Swedish products less competitive”.⁴⁹ Timonen finds that the relationship between welfare states and capital is more symbiotic than often thought and that no major Finnish or Swedish companies or corporations relocated abroad during the 1990s, despite the globalisation suggestion that increasingly mobile capital would indicate that they would relocate to the cheapest country.⁵⁰ Overall, Timonen finds

while the pressures of globalization and Europeanization on domestic politics are beyond doubt, their extent and actual impact have been exaggerated... . Globalization and social policy-making at the national level, in accordance with national wishes and “traditional” decision-making procedures, are not mutually contradictory.⁵¹

⁴³ Above n12, 491.

⁴⁴ Above n13, 10.

⁴⁵ Above n13, 10.

⁴⁶ Sven Steinmo, ‘Globalization and Taxation: Challenges to the Swedish Welfare State’ (2002) 35 *Comparative Political Studies* 839.

⁴⁷ *Ibid.*

⁴⁸ Above n33.

⁴⁹ Above n33, 1

⁵⁰ Above n33, 48.

⁵¹ Above n33, 48.

Deacon adopts a broader research perspective and investigates the impact of globalisation and social welfare in a European context.⁵² Deacon finds that different kinds of welfare state have reacted in dissimilar ways to the forces of globalisation and argues that countries that have privatised welfare provision are aligned with globalisation, but have traded-off some elements of equity. As with Steinmo and Timonen,⁵³ Deacon finds that Nordic countries “have been surprisingly sustainable in the face of global competitive pressures due to political will to maintain them”.⁵⁴ However, in some southern European countries, Deacon suggests that increased national debt has limited capacity to provide generous welfare support, which has threatened social and labour standards.

Timonen uses the example of pension reform in the United Kingdom to demonstrate the importance of pre-existing policy structures when restructuring.⁵⁵ Timonen observes that extant policies influence the likelihood of individuals to mobilise against cutback proposals. Moreover, policies that are defended by strong interest groups are less likely to be the target of reform.

G The Australasian Experience

McClelland and St John suggest three potential social policy responses to the presence of globalisation:

1. differing political ideologies, which may impact on the policy direction followed;
2. institutional influences, which constrain implementation of different policy options; and
3. different uses of neo-liberal economic and industrial relations policies, which impact on variables such as the level of benefits provided.⁵⁶

On application of these three responses to the changes in social policy in Australia and New Zealand, McClelland and St John suggest that differences in institutional arrangements may have played the most significant role.⁵⁷ McClelland and St John assert that, in particular, the relationships with the trade unions in Australia, the absence of a Senate majority by the government and the existence of State governments all acted to influence social policy outcomes.

IV DEVELOPMENT OF RETIREMENT SAVINGS POLICY IN AUSTRALIA

A Prior to 1975

Superannuation provision in Australia can be traced back to the mid 1890s with the introduction of public sector superannuation in South Australia in 1854.⁵⁸ The states of New South Wales, Victoria and Queensland all implemented state provided old-age pensions between 1900 and 1908. These pensions were non-contributory flat-rate payments, which were means and asset tested. All these schemes continued to operate

⁵² Above n9.

⁵³ Above n46 and n32.

⁵⁴ Above n9.

⁵⁵ Above n32, 28.

⁵⁶ Above n7,178.

⁵⁷ Above n8, 187.

⁵⁸ Knox provides three reasons for provision of occupational superannuation. These were; to improve efficiency within the workplace through a strategic retirement plan for older employees, secondly to remove any moral obligation that an employer may have had to support retiring individuals who had provided many years of loyal service and finally to protect employers from certain industrial actions by employees (such as fraud or withholding of labour). David M Knox, *A Review of the Options for Taxing Superannuation*, 1990, 3.

until the introduction of the *Invalid and Old Age Pensions Act 1908* and the subsequent implementation of the Commonwealth scheme in July 1909. Between its implementation in 1909 and 1940 the *Invalid and Old Age Pensions Act 1908* was amended on twenty occasions.⁵⁹ However, these changes were not significant and primarily related to changes in the pension rate and structure.

Encouragement for occupational superannuation first occurred in 1915 when legislation was passed to permit employers to deduct superannuation contributions against assessable income.⁶⁰ However, little significant change was to occur in either state provision or the treatment of voluntary retirement savings for around 70 years.

Until the 1970s the Australian pension was granted on the basis of need, with the existence of income and property tests. Means testing has been one of the more contentious areas of government provided superannuation, with numerous changes to the levels and age of eligibility over the years.

B 1975 – 1987

Prior to 1982, tax concessions for superannuation were extremely generous. Employer and employee superannuation contributions were tax exempt. Voluntary contributions to retirement savings funds were generally deductible. Tax exemptions existed for fund earnings and only five per cent of lump sum benefits were included as assessable income. Payments received in the form of a pension were assessable income. This is representative of the EET scheme which is common in OECD countries today (although lump sum payments were effectively EEE). However, despite this generosity, superannuation coverage for the general work force remained low until the 1980s.

Along with equity, a further concern with the tax treatment of superannuation in the early 1980s was the tax minimisation arrangements that were encouraged by the tax system.⁶¹ Furthermore, the tax treatment of lump sums discouraged the taking of pensions and annuities. In response to these problems, and in an attempt to preserve at least some funds for the purposes of retirement, on 1st July 1983 the Government introduced new tax arrangements, which saw an increase from five per cent of lump sum payments to the full amount included as assessable income, subject to a maximum marginal rate of 30 per cent. Contributions by employees and the self employed after 1 July 1983 that did not attract a tax deduction (known as undeducted contributions) were tax exempt.⁶²

As an incentive to preserve benefits for genuine retirement purposes, the 30 per cent tax on the first A\$55,000 of the post-30 June 1983 component was reduced to 15 per cent if taken after the age of 55. The legislation also provided tax relief where funds were rolled over into approved superannuation funds and not accessed until after the age of 55.

⁵⁹ T H Kewley, *Australian Social Security Today: Major developments from 1900 to 1978*, 1980, 17.

⁶⁰ Senate Select Committee on Superannuation, *Super Guarantee Bills*, (1992) Second report of the Senate Select Committee on Superannuation, 10.

⁶¹ The cost of tax incentives for retirement saving was estimated at A\$2 billion, and it was argued that the concessions went “mostly to people who are neither needy nor poor”. Parliament of the Commonwealth of Australia. *Economic Statement May*, 1988.

⁶² The amended tax arrangements for lump sum payments were expected to yield revenue savings of around A\$10 million in the first year, increasing to around A\$300 million over time. Parliament of the Commonwealth of Australia. *Economic Statement May*, 1988.

A significant development in relation to both industrial relations and superannuation during the early period of globalisation was the Accord between trade unions and the Government.⁶³ The Accord provided for greater government consultation and facilitated involvement by the trade unions. Six variations on the Accord occurred between 1983 and 1991. A key component of the Accord was the inclusion of occupational superannuation in the process.

It was not until December 1985 that the Labor government confirmed the introduction of occupational superannuation under the centralised wage system, determining that a three percent increase in productivity would be distributed to workers in the form of occupational superannuation. However, the National Wage Case decision applied only to Federal awards, so employees covered by State awards, or those who had no award coverage were not covered by the decision.

Tax concessions remained generous when compared to other OECD countries at this point. The cost of superannuation tax concessions were estimated for the 1985-86 financial year at A\$3.1 billion.⁶⁴

C 1988 – 1992

Australia experienced significant tax changes to retirement savings in 1988. The May 1988 Economic Statement announced that instead of applying tax of 15 or 30 per cent on final benefits,⁶⁵ funds would pay 15 per cent tax on employer contributions, while the tax on end benefits would be reduced by the same rate. By allowing earlier tax collection, the cost of the superannuation arrangements would reduce but, theoretically, without impacting on the incentive to save. Accordingly, the new tax rates on lump sums were reduced to zero on the first A\$60,000 (a concessionary indexation from the previous threshold) and 15 per cent on the remainder. In addition, pensions or annuities paid from taxed funds received a 15 per cent rebate. For lump sums withdrawn earlier, the entire lump sum was taxed at a rate of 20 per cent.

A further change was the introduction of a 15 per cent tax on superannuation fund earnings. The purpose of this was to bring superannuation funds within the imputation system for company taxation, from which they were previously excluded. However, a secondary purpose existed, which was to increase government revenue by around A\$1 billion.

Other, more minor changes included tightening the maximum benefit limits⁶⁶ and the reintroduction of graduated Reasonable Benefit Limits (RBLs) to discourage the

⁶³ The formal title is the *Statement of Accord by the Australian Labor Party and the Australian Council of Trade Unions Regarding Economic Policy*. The Accord was endorsed by a special conference of all unions affiliated to the Australian Council of Trade Unions (ACTU) in February 1983. The Accord was intended to encourage economic growth, reduce unemployment and lower inflation. Singleton writes that “the basis of the policy was agreement by the ACTU, the peak union body, to accept full wage indexation and centralized wage-fixing. In return the Hawke government would provide compensatory tax cuts, improvements to social security benefits and a range of supporting policies that would satisfy other union objectives”. Gwynneth Singleton, *The Accord and the Australian Labour Movement*, 1990, 1.

⁶⁴ Hansard, Senate, Volume 120, 26 March 1987, 1390.

⁶⁵ That is, 15 per cent on the first A\$55,000 and 30 per cent on any excess, or 30 per cent for the whole component if taken as a lump sum before the age of 55, relating to employment after 1 July 1983. Parliament of the Commonwealth of Australia. *Economic Statement May*, 1983.

⁶⁶ This change was expected to only impact on those earning over A\$70,000 per annum.

conversion of salary into tax-advantaged occupational superannuation schemes providing benefits “in excess of reasonable retirement income requirements”.⁶⁷

In 1991, the Australian industrial court (the Industrial Relations Commission) rejected an application for a further three per cent Productivity Award Superannuation increase, despite support for the application by the government and the unions. The government response was to introduce the Superannuation Guarantee Levy (the Superannuation Guarantee) in 1992. The Superannuation Guarantee started at three per cent of employee earnings on 1 July 1992, and gradually increased to nine per cent by 1 July 2002. It remains at nine per cent today and over 90 per cent of Australian workers have superannuation coverage.⁶⁸

D 1993 – 2007

During this 14 year period, changes continued to be made to superannuation and the tax treatment of superannuation. They included:

- changes to the amount of deductible contributions that could be claimed by an employer, with the removal of the ‘standard contribution limit’;
- changing Reasonable Benefit Limits from a multiple of highest average salary to fixed dollar amounts;
- a tax surcharge of 15 percent for superannuation contributions by high income earners (known as the Superannuation Surcharge);⁶⁹
- capital gains tax relief for small business owners, where a capital gains tax exemption could be claimed when a small business was sold and the proceeds were used for retirement. The exemption was available for a maximum gain of A\$500,000 under certain circumstances;
- a new savings rebate;⁷⁰ and
- introduction of more generous government superannuation co-contributions.

E 2007 Amendments

Significant changes to the taxation of superannuation benefits were implemented from July 2007. A key aim was to simplify the system and it is generally accepted that these changes have, after many years, gone some way towards achieving this. The key beneficiaries are individuals withdrawing funds from taxed superannuation funds after the age of 60. These benefits are tax free, regardless of whether they are in the form of a lump sum or a pension. Benefits paid to persons aged over 60 from an untaxed fund are taxed at 15 per cent on the first A\$700,000. Benefits above this level are taxed at the top marginal rate.

In addition, Reasonable Benefit Limits were abolished and the age-based contribution limits were amended to one level regardless of age.⁷¹ The 15 per cent tax

⁶⁷ Parliament of the Commonwealth of Australia. *Economic Statement May*, 1988.

⁶⁸ Certain exemptions apply, for example, for employees less than 18 years, very low-income earners and non-residents.

⁶⁹ Introduced in 1996, this was reduced by 1.5 per cent in each of the years from 2002 to 2005, before being removed in 2005.

⁷⁰ A tax rebate was available for personal superannuation contributions made from post-tax income up to a maximum level of A\$3,000. For low- and middle-income earners making personal superannuation contributions the first A\$1,000 of contributions attracted both the savings rebate and the existing ten per cent rebate available to individuals earning up to A\$31,000.

on contributions and fund earnings was unchanged. Personal superannuation contributions (undeducted contributions) that are not tax deductible are capped at A\$150,000 per annum while deductible contributions are capped at A\$50,000 per annum (such as employer contributions).

V DEVELOPMENT OF RETIREMENT SAVINGS POLICY IN NEW ZEALAND

A Prior to 1975

It is generally accepted that New Zealand (and Australia) at the start of the 20th century, and for some years after, were ahead of much of the world in many aspects of social policy.⁷² The seminal legislation that put New Zealand at the forefront of international social policy was the *Old Age Pension Act 1898*. The *Old Age Pension Act 1898* provided a modest pension of around one-third of a working-man's wage, with strict eligibility criteria.⁷³

After the implementation of the targeted old age pension, successive governments looked for ways to encourage people to provide for their own retirement rather than relying on state funded pensions. Incentives introduced included the establishment of the National Provident Fund in 1910, and tax concessions for investment in private superannuation, the investment earnings of superannuation funds and employer contributions to superannuation funds.

The 40 years between the *Old Age Pension Act 1898* and its successor, the *Social Security Act 1938*, did not result in any significant changes to the old age pension. The *Social Security Act 1938* introduced a dual publicly provided pension system. Individuals of retirement age who had been resident in New Zealand for 20 years could choose between an age benefit payable at age 60, which was not taxed, but was subject to an income test; and a superannuation benefit payable from the age of 65, which was not income tested, but was taxable.

B 1975 – 1987

New Zealand endured an unpopular and short-lived compulsory superannuation scheme from April 1975. Every employee aged between 17 and 65 was required to belong to either the New Zealand Superannuation Scheme, as it was known, or an approved private scheme. The scheme lasted until a change of government in 1977, at which point National Superannuation was introduced.

National Superannuation was a universal benefit available to those aged 60 years or over who satisfied a residency test. It was payable at 70 per cent of the average ordinary-time wage and financed out of ordinary government revenue on a pay-as-you-go basis. By 1981, New Zealand's spending on superannuation provision had become significantly more than other OECD countries at 17.3 per cent of government spending, compared to around 11 per cent of government spending in Australia and Britain.⁷⁴

In the early 1980s, personal contributions to superannuation funds were tax deductible to both the individual (to a limit of NZ\$800 if in an employer subsidised

⁷¹ This is A\$50,000 on an annual basis. Contributions above this amount will not benefit from concessional tax treatment and will be taxed at the top marginal rate of tax.

⁷² Francis G Castles, *The Working Class and Welfare: Reflections on the political development of the welfare state in Australia and New Zealand, 1890 – 1980*, 1985, 17.

⁷³ David Preston, *Retirement Income in New Zealand: the Historical Context*, 2001, 10.

⁷⁴ Margaret McClure, *A Civilised Community: A History of Social Security in New Zealand*, 1998, 194.

scheme or NZ\$1,000 if no subsidy was provided) and deductible to the employer up to a ceiling of NZ\$700 per employee for a lump sum benefit or ten per cent of wages or salary for a pension benefit. Earnings of the funds were not taxed and lump sum superannuation was not taxed on withdrawal. Pension superannuation funds were taxed as part of personal income on withdrawal, although in many cases pensions were commuted in some part to a lump sum on retirement, thereby avoiding tax.

In 1982, fund earnings for lump sum superannuation schemes became taxable at 33 per cent. This was expected to generate additional revenue of approximately NZ\$75 million per annum.⁷⁵ Pension payment fund earnings remained tax exempt.

In the 1984 Budget, some of the personal tax exemptions for life insurance premiums and superannuation contributions were removed.⁷⁶ These were for contracts entered into after the night of the Budget for life insurance, personal lump sum superannuation schemes and non-subsidised employee lump sum superannuation schemes. While this move brought the tax treatment of life insurance policies and personal lump sum superannuation schemes closer to a TTE income tax treatment, investment earnings were not taxed at the marginal rate of the member, but at the standard rate of 33 per cent. This was punitive for lower marginal tax rate taxpayers, and concessional for those on higher marginal tax rates. Employee lump sum schemes remained under the ETE system, with investment earnings also taxed at the standard rate of 33 per cent. Personal and employee pension superannuation schemes continued under the extant EET system. Estimated costs of these tax concessions for superannuation were NZ\$440 million of net revenue foregone.⁷⁷

The most significant change of this period occurred in December 1987 when the Government announced a number of changes to the way superannuation scheme savings were to be taxed. The key changes were:

- contributions to superannuation schemes would be from taxed income;
- income earned within superannuation schemes would be taxed at a rate approximating the marginal tax rate of fund members; and
- funds from superannuation schemes would be free of tax on withdrawal.

The aim was a 'level playing field' for investment, but a strong link was made between the removal of superannuation incentives and the introduction of lower personal tax rates. In addition, removal of the tax concessions was seen to improve equity within the tax system.⁷⁸

⁷⁵ Memo from the Caucus Committee to the Minister of Finance, 11 June 1982. New Zealand Archives reference AALR, 873, W4446, 632, 76/2/54, Part 1.

⁷⁶ After 8 November 1984, contributions to employer-subsidised superannuation funds (both pension and lump sum) were deductible up to NZ\$1,200 per annum. Contributions to personal pension schemes and non employer-subsidised employee pension schemes were deductible up to NZ\$1,400 per annum. Contributions to personal lump sum schemes and non employer-subsidised employee lump sum schemes were not deductible. Investment income of superannuation funds for lump sum policies (personal, employer-subsidised or non-employer subsidised) were subject to tax at 33 per cent from 1 April 1985. Investment income of superannuation funds for pension policies was tax exempt. Benefits from lump sum schemes were tax exempt and benefits from pension schemes were generally taxable.

⁷⁷ Memo from the New Zealand Treasury to the Minister of Finance, 23 October 1985. New Zealand Archives reference AALR, 873, W4446, 632, 76/2/54, Part 2.

⁷⁸ Tax incentives in relation to superannuation and life insurance was seen as 'to a large extent, captured by a section of society which is predominantly made up of male middle-aged professionals belonging to high-income socio-economic groups' (New Zealand Government, *Government Economic Statement*, 1987, 3). If continued into 1988/89, the tax concessions were estimated to cost the Government NZ\$800 million in tax revenue foregone (New Zealand Treasury, *Government Management: Brief to the Incoming Government 1987, Volume 1*, 1987, 21). The elimination of this

C 1988 – 1992

The election of the National Party in 1990 saw a number of proposed cuts to superannuation, as part of an overall reduction in welfare spending. Contrary to election pledges, these included ‘freezing’ the pension for three years, increasing the age of eligibility to 65 and replacing the unpopular surcharge⁷⁹ with a regime that clawed back even greater amounts of superannuation. The considerable unpopularity of these proposals saw their withdrawal in 1991, although the increase in age of eligibility remained and the surcharge was replaced with a more rigorous income test.⁸⁰

The Task Force on Private Provision for Retirement (more commonly known as the Todd Task Force) was appointed by the National Government in October 1991 to report on policy options to encourage self-reliance in retirement. As was to become the pattern for the future, the Task Force did not make any major policy reforms, although it did provide three ‘model’ options for retirement savings.⁸¹ The Task Force reiterated the need to increase savings and the need to support long term savings, but concluded that neither of these two issues provided a strong argument in support of tax incentives.

D 1993 – 2007

The 1996 election resulted in a National and New Zealand First Party coalition. The Coalition Agreement between the National Party and New Zealand First outlined the intent to introduce a compulsory savings scheme on 1st July 1998, if approved under a referendum. The proposed scheme was to have contribution rates of three per cent starting in 1998/1999, increasing to a maximum level of eight per cent in 2002/2003, with the intention of assisting each income earner to save NZ\$120,000 before retirement. When the compulsory scheme was taken to a referendum it was soundly defeated with nearly 92 per cent of voters rejecting it.⁸²

The New Zealand Superannuation Fund was introduced in 2001. The New Zealand Superannuation Fund is intended to partially fund the future cost of New Zealand Superannuation through a ‘smoothed pay-as-you-go’ approach. The Fund will take contributions from budget surpluses to 2025, after which time it will be drawn on to help fund the future costs of superannuation.⁸³

tax expenditure allowed for a reduction in overall income tax rates by about 2.5 cents per dollar for all taxpayers, after making superannuation benefits non-taxable.

⁷⁹ The surcharge was introduced by the Labour government in 1985.

⁸⁰ As a result of the changes the share of the universal pension cost reduced from nearly eight per cent of GDP in the early 1980s to just over five per cent by the late 1990s. Above n73, 18.

⁸¹ The three options were a voluntary ‘neutral’ option based on the existing tax regime for savings, an incentive option based on tax concessions and a funded compulsory option requiring contributions from employees and the self-employed.

⁸² The proposed scheme had significant opposition from a number of areas, including two-thirds of National Party cabinet ministers, the major opposition parties, trade unions, the Employer’s Federation and Grey Power (Kent R Weaver, *New Zealand: The supreme political football*, Center for Retirement Research at Boston College, 2002, 23).

⁸³ Demographic changes are the key factor in determining the need for the New Zealand Superannuation Fund. In the 2002/03 period New Zealand Superannuation accounted for 57 per cent of core benefit expenditure (NZ\$4.8 billion) or around four per cent of GDP (J Davey, *Social Monitoring and the Challenge of an Ageing Population*, Paper prepared for The Visible Hand Symposium, Victoria University of Wellington, November 2004, 1). Demographic projections forecast New Zealand Superannuation expenditure to remain around this level until around 2012, at which point the numbers of people claiming superannuation are projected to increase, rising to nine per cent of GDP around 2050.

The Savings Product Working Group report in 2004 suggested the introduction of an automatic enrolment scheme when commencing new employment.⁸⁴ This scheme (named KiwiSaver) was accepted by the government and implemented in July 2007.

E 2007 Amendments

The introduction of KiwiSaver accounts in July 2007 initiated an important change in New Zealand retirement savings policy. KiwiSaver is an automatic enrolment occupational retirement savings scheme that is activated when an individual commences new employment. While it is not compulsory, the onus is on the taxpayer to 'opt out' of the scheme if membership is not desired. A NZ\$1,000 contribution to each new KiwiSaver account is made by the government together with some fee subsidisation. In some cases, after a minimum contribution period, the fund may be used as a deposit towards a first home purchase.

A further indication of a significant policy direction change was the 2006 announcement of an exemption from Specified Superannuation Contribution Withholding Tax for employer contributions to KiwiSaver schemes or other complying funds. The tax exemption was for the lower of the amount of the employee's contribution or four per cent of the employee's gross salary or wages. In addition, with effect from 1 July 2007 employees and self-employed individuals who are part of the KiwiSaver scheme will qualify for a tax credit of up to NZ\$20 per week for their KiwiSaver contributions. This is effectively an equal matching credit up to NZ\$20, which will be paid annually into the person's KiwiSaver account.

In addition, and perhaps the most significant change in retirement savings policy in the last two decades, from 1 April 2008 a compulsory matching employer contribution will commence. This will be phased in over a four year period, starting at one per cent of gross income in 2008 and increasing to four per cent by 2011. Employer contributions will also qualify for a matching tax credit up to NZ\$20 per week, which will be made available to the employer to offset the contribution cost. The cost of these proposals is forecast to be NZ\$680 million in the 2008/2009 income year, assuming a 50 per cent acceptance rate.

VI INTERNATIONAL INFLUENCE

The influence of global organisations on social policy is manifested in different ways in different countries. Of particular relevance for the taxation of retirement savings is the World Bank model. Typically, the World Bank advocates welfare policies that include a basic state provided safety-net with privatised welfare support.⁸⁵ For example, the World Bank recommends a three-tier model for retirement savings: state provision, compulsory occupational schemes and private voluntary savings.⁸⁶ All OECD countries have developed first-tier schemes, although these are of different types including social assistance, separate targeted retirement income programmes, basic pension schemes and minimum pensions within earnings-related plans.⁸⁷ All OECD countries, with the exception of New Zealand and Ireland,

⁸⁴ Savings Product Working Group, *A Future for Work-Based Savings in New Zealand*, 2004.

⁸⁵ Above, n9.

⁸⁶ World Bank, *Averting the Old Age Crises*, 1994, 15.

⁸⁷ For further detail on these schemes refer to Organisation for Economic Co-operation and Development, *Pensions at a Glance: Public Policies Across OECD Countries*, 2005, 22.

also have contributory state schemes and extensive state involvement in private superannuation arrangements.

Until mid-2007, New Zealand operated a two-tier system: a basic state pension paid from general revenue and voluntary private savings. While there are still no compulsory savings arrangements in New Zealand, a small tax incentive was introduced with KiwiSaver accounts in July 2007.

The Australian pension system has had three tiers for many years, with two tiers of state involvement. The first tier is a means-tested pension. The second tier is the Superannuation Guarantee. Among OECD countries, Australia has the largest mandatory defined contribution scheme, where employers pay nine per cent of their employees' earnings into a pension account. In addition, voluntary private savings schemes exist.

Perhaps the best indication of the extent to which global policies have been adapted in retirement savings is by a simple comparison of the basic approaches adopted. Typically, it is expected that countries with comparable levels of development will respond to similar problems with similar methods. In part, this can be explained by the limited number of possible policy solutions, but also in part due to increasing interdependence between countries. The policies for the taxation of retirement savings policy in a number of OECD countries are outlined in Table 1. The table indicates that an EET approach is the most common system among OECD countries.⁸⁸ New Zealand and Australia are both conspicuous outliers in their approach to the taxation of retirement savings.

Table 1: Tax Treatment of Private Pensions in Selected OECD Countries⁸⁹

EET		ETT	TTE	
EEt	EET		tTE	ttE
Belgium	Austria	Denmark	New Zealand	Australia
France	Canada	Italy		
Germany	Finland	Sweden		
Ireland	Greece			
Japan	Iceland			
Korea	Netherlands			
Mexico	Norway			
Portugal	Poland			
Slovak Republic	Switzerland			
Spain	United States			
Turkey				
United Kingdom				

While the similar 'coding' may appear to indicate that the tax systems are alike in Australia and New Zealand, in reality the systems are quite different. While tax is levied at similar times, the levels of tax concession at these points provide for different levels of encouragement for retirement saving in each country.

⁸⁸ Refer to Part II for explanation of these acronyms.

⁸⁹ Adapted from Kwang-Yeol Yoo and Alain de Serres, *Tax Treatment of Private Pension Savings in OECD Countries*, 2004.

To ascertain the impact of international input into New Zealand and Australian policy approaches, interviews were conducted with a number of individuals who were involved in the development of retirement savings policy from the mid-1980s in New Zealand and Australia. When Australian participants were asked if international policy influenced the Australian policy in the mid-1980s and early 1990s, typically the response received was that there was none. The following comment from a senior Australian bureaucrat is representative: “No. There was no international influence: none at all. We were aware that what we were doing was unique, but our starting point was unique”.

When interview participants in New Zealand were questioned about international influence on New Zealand policy development during the same time, they cited a wider range of international sources.⁹⁰ However, while there was interest within the New Zealand Treasury of what international researchers were advising, this did not necessarily translate into acceptance of these views. A senior New Zealand bureaucrat advised:

We were trying to do things on a ‘first-best’ basis. We took account of the theoretical positions and tried to work from that to practical policy, but we didn’t put a lot of weight on what other countries did ... if they didn’t make economic sense, we weren’t influenced by them. We weren’t into the business of matching them.

Outlining a similar view, a senior New Zealand bureaucrat advised: “in those days we were very heavily driven by what was right theoretically – not what the rest of the world was doing – so it didn’t have much impact”. Nonetheless, individuals such as Ian Harper and Ted Sieper (both Australian academics) were influential in the New Zealand policy process in the mid-1980s; Ian Harper through the presentation of the paper *Taxation of Superannuation in New Zealand: Agenda for Reform*, and Ted Sieper through his work with the New Zealand Treasury in the mid 1980s.⁹¹ However, it should be noted that both academics supported the position that the New Zealand Treasury had made it apparent that it wanted to adopt.⁹²

The policy approach of New Zealand continued to resist global influence in the early 1990s, at the time when Australia was implementing a compulsory retirement savings scheme. The New Zealand Task Force on Private Provision for Retirement analysed international approaches to retirement savings, concluding that each country’s

⁹⁰ Such as the Committee of Inquiry into the Australian Financial System in 1981 (also known as the Campbell Committee report), an Australian report on the financial industry, which entered into a comprehensive discussion on tax incentives.

⁹¹ Ian Harper, *Taxation of Superannuation in New Zealand: Agenda for reform*, Paper presented to a seminar on the Taxation of Superannuation in New Zealand, Wellington, May 1985.

⁹² The views of the New Zealand Treasury are apparent from the start of the 1980s. For example, correspondence in 1980 states “ideally the tax system should not favour any one type of savings instrument...” (correspondence from the Treasury to the Minister of Finance, 12 May 1980. New Zealand Archives reference AALR, 873, W5427, Box 1898, Record 76/13/6, Part 1). Statements in a Treasury Report of May 1982 include “it is desirable that the tax system be as neutral as possible between different activities including between the variety of financial instruments and institutions available in the capital market” and “it would be desirable to introduce neutral tax treatment for superannuation funds as soon as possible” (New Zealand Treasury Report T76/3/6/1, New Zealand Archives reference AALR, 873, W5427, Box 1898, Record 76/13/6 Part 4). Correspondence from the Treasury in 1985 suggests “there is no reason why the Government should encourage and subsidise saving for retirement any more than precautionary saving for illness, unemployment or indeed someone’s saving for a consumer item such as a new video” (correspondence between Treasury officials, September 1985, New Zealand Archives reference AALR, 873, W4446, Box 632, Record 76/2/54 Part 2).

retirement arrangements were individual to that country and it was difficult to draw lessons from another country.⁹³ A New Zealand Reporting Group member advised “our distinctive national superannuation arrangements were quite unique and while we had some information from overseas jurisdictions we actually didn’t draw on it to much extent at all”. Meanwhile, Australian academic John Piggott, in a submission to the Australian Senate Select Committee on Superannuation in 1992, wrote that “almost all comparable countries require more or less compulsory participation in national retirement income schemes. This suggests that there are widespread reservations about relying on voluntary saving to adequately self-provide for retirement. There are some good reasons to entertain such reservations”. However, these reservations did not seem to be reflected in the New Zealand debate.

A plethora of New Zealand government instigated reports were produced from the mid 1990s onward from organisations such as the New Zealand Treasury.⁹⁴ Generally these reports found the extant arrangements to be, if not ideal, at least satisfactory. A typical example is the claim by the Periodic Report Group that the system is: “flexible enough to deal with the changes we will face over the next 50 years and that New Zealand is better able to adjust to those changes than many other countries”.⁹⁵

The absence of global influence in New Zealand policy for retirement savings is seen in some of the key events in New Zealand’s retirement savings policy since the mid-1990s, such as the attempt to introduce a compulsory occupational retirement savings scheme in 1997. It was recognised at the time that the issues supporting the proposed scheme were not unique to New Zealand and the compulsory scheme would achieve the result of shifting part of the cost of future retirement benefits to the current taxpayers. However, despite the international evidence supporting compulsion, and the successful uptake by Australia, the referendum was soundly defeated and the issue of compulsion has not prompted serious debate since this time.

The implementation of the New Zealand Superannuation Fund is another example of policy making that was uncommon among OECD countries. The Fund was established in 2001 with the aim of pre-funding some of the future cost of New Zealand Superannuation. As at August 2008, fund assets were NZ\$14.5 billion.⁹⁶ Contributions to the fund, of \$1.5 billion per annum, are contingent on government surpluses. Ireland (the only other OECD country that also does not have a compulsory occupational retirement savings scheme) has adopted a similar policy arrangement. Ireland’s National Pension Reserve Fund is significantly larger than

⁹³ New Zealand Task Force on Private Provision for Retirement, *Private Provision for Retirement: The way forward – final report*. Final Report of the Task Force on Private Provision for Retirement, December 1992.

⁹⁴ For example, Iris Claus and Grant Scobie, *Household Net Wealth: An international comparison*, New Zealand Treasury Working Paper 01/19, 2001; Iris Claus and Grant Scobie, *Saving in New Zealand: Measurement and Trends*, New Zealand Treasury Working Paper 02/02, 2002; New Zealand Treasury, *Savings Incentive Options, Consultation and Analysis*, New Zealand Treasury Report 7, 2001; Periodic Report Group, *Retirement Income Report: A review of the current framework*, Interim Report, 1997a; Periodic Report Group, *Retirement Income Report: Building Stability*, Concluding Report, 1997b; Periodic Report Group, *Retirement Income Report*, 2003; Grant Scobie, John Gibson and Trinh Le, *Saving for Retirement: New evidence for New Zealand*, New Zealand Treasury Working Paper 04/12, 2004; Grant Scobie, John Gibson and Trinh Le, *Household Wealth in New Zealand*, Institute of Policy Studies, Wellington, 2005; Grant Scobie and Trinh Le, *The Impact of Workplace and Personal Superannuation Schemes on Net Worth: Evidence from the Household Savings Survey*, New Zealand Treasury Working Paper 04/08, 2004.

⁹⁵ Periodic Report Group. *Retirement Income Report: A review of the current framework*, Interim Report, 1997a, 4.

⁹⁶ New Zealand Superannuation Fund, www.nzsuperfund.co.nz, October 2008.

New Zealand's fund, with assets of approximately €20 billion (or approximately NZ\$45 billion) at the present time.⁹⁷ Ireland has a population size similar to that of New Zealand, a pre-funding arrangement currently around three times that of New Zealand, a state pension scheme that is less generous than that of New Zealand and around 55 per cent workforce participation in superannuation schemes. These factors indicate that Ireland is considerably more prepared to manage its ageing population in retirement than New Zealand.

It has only been in recent times that the New Zealand Treasury has set out a current position on saving. Prior to 2007, New Zealand Treasury working papers (while not strictly purporting to represent a Treasury viewpoint) have argued that while levels of savings in New Zealand appear low, there was no strong case for any form of intervention. However, in May 2007 the New Zealand Treasury position paper notes the need to adopt a 'least-regrets approach' to policies for savings in the absence of good quality data on which to base decisions and "the possibility that individuals are basing saving decisions on long-run expectations that could turn out to be mistaken".⁹⁸

More recent policy, and in particular the introduction of KiwiSaver accounts in 2007, is the first indication that New Zealand is taking into account a more globally accepted approach to retirement savings and its taxation. The introduction of a small tax incentive has resulted in a high uptake of KiwiSaver accounts, at around one-third of workers, but the future of KiwiSaver remains uncertain in the current political environment.

Conversely, the Australian approach has been more sympathetic towards global policy, despite not appearing to actually be actively adopting an international approach. The introduction of the compulsory occupational savings scheme, the Superannuation Guarantee, was well received in Australia. It was supported by evidence of ageing populations, together with explanations of how individual's would benefit in retirement through active saving over their working lifetimes. Furthermore, the policy was implemented in association with influential groups, such as the trade unions, which assisted in promoting its benefits. There was little disagreement among interested parties in the introduction of compulsory retirement savings in Australia. Furthermore, Australia has continued to support voluntary retirement savings through tax incentives, which have recently become even more concessionary.

The debate on the merits of voluntary versus compulsory savings seems likely to continue in New Zealand. This is despite the generally accepted global perspective that it requires many years of saving at a level of around 10 per cent of salary to maintain an association between working and retirement standards of living. This level of required savings is recognised in the New Zealand June 2006 Official's Report on the KiwiSaver Bill, with the inclusion of figures that are replicated in Table 2 below. The figures shown in Table 2 are the savings rate that is required to *supplement* New Zealand Superannuation to achieve a 70 per cent income replacement in retirement. Therefore, an individual earning the average income of around NZ\$40,000 would need to start saving the minimum level supported by KiwiSaver (four per cent) from the age of 25 to achieve 70 per cent of the average income in retirement, while still receiving the full amount of New Zealand Superannuation.

⁹⁷ Jerry Moriarty, 'Pensions and the Tax System – The "Cost" of Tax Incentives' (2008) *The Irish Tax Review*, 69.

⁹⁸ New Zealand Treasury, *A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving*, New Zealand Treasury Report T2007/654, 2007, 4.

Table 2: Contribution Rate Required for 70 per cent Income Replacement in Retirement (including New Zealand Superannuation)

Age	Income			
	\$30,000	\$40,000	\$50,000	\$60,000
25	2%-5%	4%-7%	5%-8%	6%-8%
30	3%-6%	5%-8%	7%-10%	8%-10%
40	4%-10%	9%-14%	11%-15%	12%-16%

When officials' were recommending an approach for the future of New Zealand retirement savings in 2006, the lack of support for compulsion was apparent. The Officials' Report on the KiwiSaver Bill states "officials do not recommend compulsory contributions funded by tax cuts".⁹⁹ This approach was supported by the 'usual' arguments, such as equity and cost.

More recently, the 2007 Retirement Commissioner's report has found that New Zealand has "an accessible, portable and highly incentivised savings scheme in KiwiSaver" and "this Review finds no reason to financially incentivise saving for retirement further, or to make it compulsory".¹⁰⁰ Aside from the perhaps embellished claim that Kiwisaver is 'highly incentivised' (at its peak KiwiSaver will attract a four per cent compulsory employer co-contribution), the unique path that New Zealand continues to follow for retirement savings taxation continues. Among other claims in this report, is the finding that "New Zealand retirement income policy is working reasonably well for the currently retired and those approaching retirement". Commentary is lacking on the increasing numbers of individuals that will retire one, two or three decades after the two groups highlighted as being satisfactorily accommodated under the extant arrangements.

It is acknowledged that the state is required to respond to influences beyond that of global markets. Pressures from internal interest groups, historical patterns and cultural impacts will all influence the direction of social policy. In both countries, interview data indicates that more 'local' factors were the key policy drivers and globalisation (at a micro level) had little impact. The key factors in New Zealand related to the environment; the economic crisis and the need for tax reform to improve distortions in the tax system and improve neutrality. Australia's direction was also informed by the environment and economic difficulties. However, three other factors are more apparent in the Australian situation; institutional arrangements were viewed as having a greater influence over the policy direction (such as the union movement and the Prices and Incomes Accord), there was a concern with levels of national savings that was not apparent in New Zealand and the debate focused more on equity issues than economic efficiency.

What may be framed as path dependency appears to be influential in both countries. It is generally recognised that social policy is highly resistant to change and historical policy tends to have a strong impact on future policy. In the case of the policy under investigation, path dependency may take the form of a cultural expectation; New Zealand has a long history of generous state-provided superannuation. Since the 1930s, New Zealand has been known as a 'welfare state' providing universal income support for those in need. Furthermore, since 1975, superannuation in New Zealand has been provided at a minimum of 60 per cent of average weekly earnings. This has

⁹⁹ New Zealand Treasury, *Officials' Report on the KiwiSaver Bill*, 2006, 15.

¹⁰⁰ New Zealand Retirement Commission, *2007 Review of Retirement Income Policy*, 2007, 4.

resulted in a system that would be difficult for any government to target for retrenchment. That the government does not follow the OECD trend and also spend significant sums of money on tax incentives to encourage additional retirement savings may not be surprising in the face of generous universal provision.

Historically, Australia has had less generous state provision and more of a 'safety net' approach. A factor that is also important in this context is that Australia has had a long tradition of negotiation through the industrial relations structure (the Conciliation and Arbitration system). This subsequently resulted in negotiation of the Prices and Incomes Accord, which was to become the foundation of the Superannuation Guarantee.

Despite the doom and gloom predicted by the strong global theorists, the reality is that the welfare state in most OECD countries remains largely 'unharmful' from the onset of globalisation. Reference to the most recent OECD Social Expenditure Database¹⁰¹ indicates that total public social expenditure has (as a percentage of GDP), for most countries, had an upwards trend over the two decades between 1981 and 2001, as seen in Figure 1. The OECD average over this 20-year period has increased from 17.7 per cent of GDP in 1980 to 21.8 per cent of GDP in 2001.

Furthermore, as seen in Figure 2, a similar picture emerged for public social expenditure on old age in many countries. The OECD average has increased from 5.6 per cent of GDP in 1980 to 7.9 per cent of GDP in 2001. This increase may be partly the result of ageing populations, but to provide support for the strong globalisation theory the expenditure would be expected to reduce or stabilise.

It is also important to acknowledge that the state is not the only actor in the policy development process. Globalisation theories focus primarily on the impact of globalisation on the power of the state to influence policy direction. The reality appears to be that 'institutions' such as interest groups, individual bureaucrats or politicians, employer organisations and unions, to name just a few, are all likely to influence policy direction. This can be seen in the Australian situation with the influence of the unions on policy direction. It can also be seen in New Zealand with the strong influence that the New Zealand Treasury had on the policy process. A further indication from the interviews undertaken is that specific individuals (e.g. Roger Douglas in New Zealand and Paul Keating or Bill Kelty in Australia) were also influential in shaping policy in each country.

Ultimately, it may be that New Zealand now has no option but to follow the path set by other OECD countries. Recent figures indicate that private incomes of retired New Zealanders have declined over the past 20 years, since the removal of tax incentives for retirement savings.¹⁰² Furthermore, when levels of retirement savings or participation in occupational superannuation are compared across countries, New Zealand does not return impressive results. Australia now has in excess of A\$1.3 trillion in managed funds (around 60 per cent of which is in superannuation funds) and over 90 per cent of the workforce covered in occupational superannuation

¹⁰¹ Organisation for Economic Co-operation and Development, *OECD Social Expenditure Database*, 2007. The OECD Social Expenditure Database provides data on a number of indicators of social policy, including old age, health, unemployment and other social policy areas.

¹⁰² Ministry of Social Development, *Positive Ageing Indicators*, 2007, 26.

Figure 1: Total Public Social Expenditure as a Percentage of GDP¹⁰³

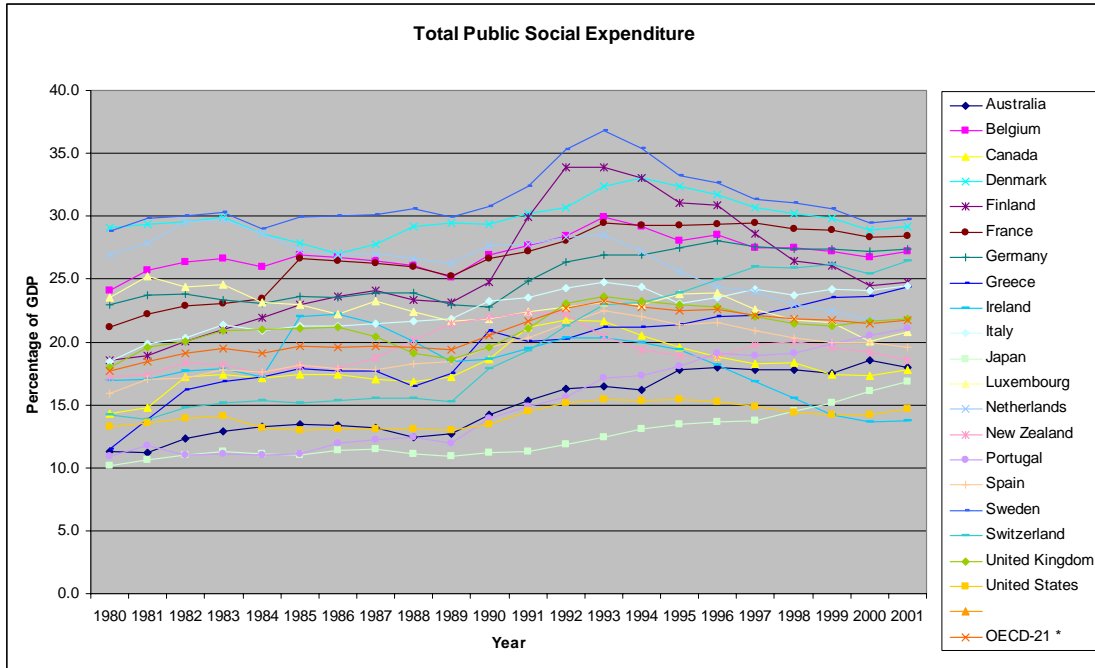
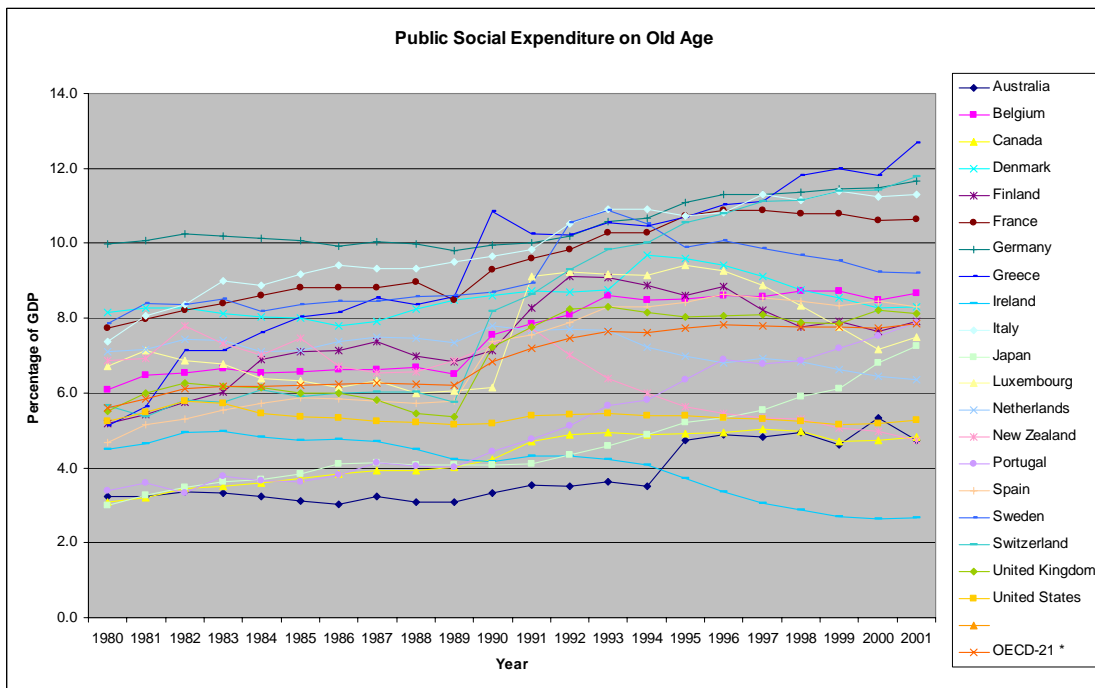


Figure 2: Public Social Expenditure on Old Age as a Percentage of GDP¹⁰⁴



¹⁰³ OECD Social Expenditure Database. Above, n101.

¹⁰⁴ OECD Social Expenditure Database. Above, n101.

schemes. New Zealand has around NZ\$60 billion (approximately A\$53 billion) in managed funds (of which about a third is in superannuation funds) and 13 per cent of active members in employer occupational schemes in 2007.¹⁰⁵

It would be unfair to say that the New Zealand approach has been unsuccessful as, until recently, there has been no indication of a policy objective to increase either private savings or participation in superannuation funds. Conversely, these were both promoted objectives in the Australian environment. Thus, criticism of the New Zealand approach on these grounds is unfounded. However, what may be justified is some questioning of why the New Zealand policy objectives were so different from the rest of the OECD.

While Australia adopted a different form of taxation of retirement saving, it remained highly concessional over the time period investigated, in accordance with other OECD countries. It would appear that globalisation theories, and in particular the 'strong' globalisation theory, do not assist in explaining either the Australian or the New Zealand approach to retirement savings. However, in the case of New Zealand, some reference to 'global wisdom' in policy adoption may be warranted, rather than continuing an experimental policy in isolation to the rest of the OECD.

VII CONCLUSION

There are two key points that arise from this analysis of the literature and the investigation of the retirement savings policies of New Zealand and Australia. Firstly, more recent literature tends to support the contention that globalisation has not limited the ability of countries to retain, or even expand, their welfare state. The greatest influence on welfare state spending is likely to be economic performance.¹⁰⁶ Secondly, just as research has shown that globalisation has not resulted in policy convergence, and as can be witnessed by the examination of New Zealand and Australian policy, globalisation has not placed any apparent restrictions on the retirement savings policy implemented. Both countries were aware of international direction, but neither appeared to be unduly influenced by these trends. New Zealand appeared to seek wider international input into policy direction than Australia, but New Zealand was the country to adopt a scheme for retirement savings that was further away from that of the generally accepted OECD model.

One suggestion that may be proposed from this research is that globalisation has a greater impact at a macro level. At the detailed policy stage it may be that a country's reference to the global arena is less relevant and factors such as history, culture, institutions and even ideology take precedence. This appears to have relevance in both New Zealand and Australia, with factors such as the presence of a generous universal system in New Zealand limiting the appeal for occupational superannuation and the historical arbitration process in Australia facilitating implementation of employment-based superannuation. Other 'local' factors such as the economic environment also appear to play a significant role in the policy direction adopted.

The benefits among New Zealand's approach are not disputed (it is simple, universal and does not discourage employment in later years). However, what is challenged is whether these benefits are sufficient to justify its continuation with the forecast

¹⁰⁵ Ministry of Economic Development Insurance and Superannuation Unit, *Report of the Government Actuary for the Year Ended 30 June 2008*, 2008. Figures are for the year ending 31 December 2007. However, figures are based on returns for balance dates as at March 2007, therefore they do not capture the introduction of KiwiSaver.

¹⁰⁶ Above n19, 330.

demographic changes, an uncertain future economic environment and increasing costs associated with an ageing population, such as health and pensions. Combined expenditure on health and New Zealand Superannuation is forecast to rise from around 11 per cent of GDP at the start of the century to around 19 per cent by 2051. The 'safety net' of the New Zealand Superannuation Fund appears to have ended its run of exemplary returns and will only be the recipient of future funds to the extent that the government runs a surplus over future years; these are all factors that lend great uncertainty to the retirement savings approach adopted by New Zealand.

The outcome for New Zealand is that its late adoption of incentives for retirement savings, combined with a 20-year record of poor savings, leaves the country's retired individuals ill-prepared to face the future. The inter-generational pressure that may arise from the future costs of superannuation is likely to result in a need for increased taxes, which may exacerbate New Zealand's extant problems with retention of skilled workers. Furthermore, unlike Australia, the absence of strong capital markets in New Zealand,¹⁰⁷ at least in part resulting from an absence of low savings, results in minimal equity to support innovative business opportunities, potentially impacting negatively on New Zealand's future economic prospects.

¹⁰⁷ In June 2008, the value of domestic companies listed on the New Zealand Stock Exchange was NZ\$48.8 billion (A\$43 billion), compared with A\$1,288 billion listed on the Australian Stock Exchange. When using a multiplier of five to adjust for the different economy sizes, the Australian Stock Exchange is approximately six times the size of New Zealand's Stock Exchange.

PART IVA AND WASH SALE ARRANGEMENTS – WILL IT ALL BECOME CLEAR IN THE WASH?

PATRICIA O'KEEFE*

This paper concerns the recently released Taxation Ruling TR 2008/1 regarding the application of Part IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) to “wash sale” arrangements. The paper proposes that the Ruling, and the legislation on which it is based (Part IVA of the ITAA 1936), will present problems for investors and advisors due to vagueness and uncertainty. Both Part IVA and the ruling are drafted in very broad, general terms and do not provide the specific guidance and certainty required for taxpayers to be able to confidently interpret and predict which transactions will be covered by the ruling. This is perceived as a serious problem given the number of taxpayers that could be affected by the ruling. The paper covers a brief history of the legislation currently relating to the use of wash sales. It then critically appraises this legislation and the ruling mentioned above in terms of their vagueness and lack of guidance offered to taxpayers and advisors. It discusses possible “solutions” to the problems discussed relating to the ruling and cites the US and Canadian rules concerning wash sales as a possible alternative that could be followed.

I INTRODUCTION

The Australian Taxation Office recently released Taxation Ruling TR 2008/1 regarding the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) to “wash sale” arrangements. A wash sale involves the sale and subsequent repurchase of the same, or substantially the same, asset within a short period of time. The result is that there is effectively no change in the economic exposure of the owner to the asset. The purpose of the transaction is to incur a capital loss which can be used to offset capital gains made in the same, or a subsequent, financial year. The taxpayer thereby offsets the gains but still effectively owns the same asset as they did before the transaction, albeit with a lower cost base than the asset originally had. The ruling also covers transactions where shares are transferred to family members, companies or trusts that are controlled by the same person, again incurring a capital loss without losing economic exposure to the asset.

This paper proposes that the Ruling, and the legislation on which it is based (Part IVA of the ITAA 1936), will present problems for investors and advisors due to vagueness and uncertainty. Both Part IVA and the ruling are drafted in very broad, general terms and do not provide the specific guidance and certainty required for taxpayers. Any ruling covering share dealings will affect many taxpayers, not only large corporations, but salary and wage earners who “dabble” in the stock market. In its *2006 Australian Share Ownership Study*, the ASX found that approximately 7.3

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million people, or 46% of the Australian population aged 18 years or more, participated in the Australian Share Market, either directly via shares or indirectly via a managed fund.¹ Six million people or 38% were direct investors. These numbers are down on the 55% share ownership levels recorded in the 2004 study when Australia had the highest reported level of share ownership in the world.² The 2006 study also showed that shareholders are more active in their investment activities and hold, on average, more companies in their portfolio than in the past. The ruling will therefore affect a large percentage of the taxpaying population, including many “average” salary and wage taxpayers, some of whom would no doubt prepare their own tax return without the help of a tax agent.

One of the biggest problems faced by taxpayers, tax practitioners and tax administrators is when legitimate tax planning crosses the line and becomes tax avoidance.³ This is not helped by the fact that it is difficult to explain why the Commissioner applies Part IVA in some circumstances and not in others. This has led to frustration on the part of taxpayers and advisors who are unable to predict accurately the likely application of Part IVA to transactions.⁴ This paper does not intend to question whether a “true” wash sale transaction should come under the definition of anti-avoidance or is simply a legitimate method of tax planning in light of the way the capital gains tax regime operates. This could be another paper in its own right. Instead the paper assumes that wash sales are a type of tax avoidance and intends to question whether the use of Part IVA provides the best and clearest “solution” to deterring the use of wash sales whilst still allowing for the legitimate buying and selling of securities to take place. The paper will, in particular, concentrate on the sale (to an unrelated party) and then repurchase of the same or substantially the same asset rather than the transferring of assets to related parties. The legitimate sale of shares and then repurchase of the same or similar shares is considered to be something that the “average” taxpayer, even those who do not consult a tax advisor, might consider doing. This paper will investigate the implications of the new ruling and the amount of guidance it offers to these taxpayers.

The first part of the paper will cover a brief history of the legislation currently relating to the use of wash sales. The paper will then critically appraise this legislation and the ruling mentioned above in terms of their vagueness and lack of guidance offered to taxpayers and advisors. It will then discuss possible alternatives to the use of Part IVA and the Ruling and finally will make a recommendation as to an alternative route that could be followed.

II WHY USE WASH SALES?

Before 20 September 1985 Australia did not have a comprehensive scheme for the taxation of capital gains. Certain capital gains were taxable under s 25A (ITAA 1936), which covered profits from the sale of property acquired for the purpose of profit-making by sale or a profit making scheme, and s 26 AAA (ITAA 1936), which

¹ Australian Securities Exchange, *2006 Australian Share Ownership Study* (2006) <www.asx.com.au/media> at 1 November, 2007.

² Australian Securities Exchange, *2004 Australian Share Ownership Study* (2004) <www.asx.com.au/media> at 1 November, 2007.

³ G. T. Pagone, ‘Tax Planning or Tax Avoidance’ (2000) 29, *Australian Tax Review*, 96.

⁴ Graeme Cooper, ‘The Emerging High Court Jurisprudence of Part IVA’ (2006) 9 *The Tax Specialist*, 5.

covered profits on the sales of property held for less than 12 months.⁵ Thus, for the majority of taxpayers who bought shares with the intention of keeping them as an investment there was no need to consider wash sales as the gains made on the sale of the shares were generally not taxable. However once the capital gains provisions were introduced in 1985 net capital gains, as determined by s 102-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), are now included in statutory income under s 6-10 (s 10-5) (ITAA 1997). Under capital gains legislation only net capital gains are included in assessable income. Net capital gains are calculated by subtracting any capital losses made during the current income year from total capital gains and then subtracting any losses from earlier income years. Net capital gains are taxable in the year in which they are realised but net capital losses cannot be used to offset ordinary income from other sources. As capital losses can only be used to offset capital gains, they must be quarantined and carried forward if they exceed the amount of capital gains in any particular year.

The wash sales arrangement offers an attractive option for investors who have made gains during a year and at the same time are carrying unrealised losses on other investments, investments which they still wish to hold. Any taxpayer who has a capital gain during a year is certainly entitled, under the law, to realise any capital losses they are carrying. For example, if a taxpayer sells one parcel of shares and makes a gain and they know they have another parcel where the market value is below their cost base, they are certainly able to sell those shares and offset the loss. It is when they immediately buy back the same shares, as if they never actually wished to sell them in the first place, that a wash sale occurs. The purpose of doing this is to incur the loss whilst continuing to hold the shares. But what happens when a taxpayer sells some shares at a loss with a genuine intention to stop holding the shares and then, at some time after the sale and owing to some unforeseen circumstances, changes their mind about the shares and decides they would like to repurchase them? These are the taxpayers who may be unfairly caught by the new ruling and current legislation which provide little certainty for these taxpayers.

III THE LAW AT THE MOMENT

A Part IVA

The use of wash sales is considered to be a type of tax avoidance by the ATO. In Australia there are several specific anti-avoidance rules in both the ITAA 1997 and the ITAA 1936, for example, Div 165 of the 1997 Act limiting deductibility of company tax losses. There are, however, no specific rules covering the use of wash sales. Their use has generally been covered by Part IVA (ITAA 1936). Part IVA came into operation on 24 June 1981 (before the introduction of capital gains tax) and was introduced as a general anti-avoidance measure.

Part IVA can apply to arrangements entered into after 27 May 1981 and will apply if it can be established that there is a scheme (s 177A), that the taxpayer has obtained a tax benefit (s 177C) and that the scheme was entered into for the purpose of obtaining the tax benefit (s 177D). Part IVA enables the Commissioner to cancel the tax benefit obtained by the taxpayer from such a scheme (s 177F). Penalties can be imposed on the taxpayer under Subdivision 284C of the *Taxation Administration Act, 1953* (Cth) (TAA). For Part IVA to apply the “scheme”, “tax benefit” and “purpose”

⁵ Michael Kobetsky et al, *Income Tax: Text, Materials and Essential Cases* (6th ed, 2006) [8.10].

must all be linked together and interpreted as a whole when determining the final conclusion. For example, whilst a tax benefit may exist, this will not be sufficient for Part IVA to apply unless the dominant purpose of the transaction or scheme was to derive a tax benefit.⁶

The term “scheme” is defined very broadly in s 177A (i) as

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether enforceable or not enforceable, or intended to be enforceable, by legal proceedings and
- (b) any scheme, plan, proposal, action course of action or course of conduct.

The breadth of this definition is obvious and the courts have sought to apply some limitations to help in the interpretation of what constitutes a scheme for Part IVA. In *FCT v Peabody* the High Court held that although the Commissioner had identified a scheme as covering a wide series of transactions he was entitled to rely on a narrower range. This indicated that a broad interpretation of the word “scheme” could apply. However, the High Court found that to constitute a scheme the set of circumstances had to be capable of “standing on their own” without being “robbed of all practical meaning”.⁷ This requirement may no longer be necessary following the decision in *FCT v Hart* where Gummow and Hayne JJ indicated that it was not necessary for the scheme to stand on its own and that the scheme could encompass just the taking of one step.⁸ Although no decision has been made on this point, it would seem that if a scheme can be narrowed down to the taking of the one step that involves a tax benefit then there is no reason to inquire as to the dominant purpose of the scheme as it will always be to obtain a tax benefit. The “scheme” with regard to wash sales is likely to include all the steps involving the sale and repurchase of securities or the transfer of securities to a trust or company.⁹

The second requirement is that a “tax benefit” must have been obtained. The meaning of “tax benefit” is defined in s 177C (1). Originally Part IVA did not cover tax benefits from capital losses. However, s 177C (1) (ba) states that a tax benefit will include

a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out.

This section relates to schemes entered into after 3 pm on 29 April 1997. The tax benefit obtained in the majority of wash sales is a capital loss that can be used to offset capital gains realised in the same or subsequent years.

The third requirement for Part IVA to apply is that the scheme must have been entered into for the “dominant purpose” of obtaining a tax benefit. S 177D lists eight factors that must be taken into account in determining the “dominant purpose”. These 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;
- (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

⁶ *FCT v Hart* (2004) 55 ATR 712.

⁷ *FCT v Peabody* (1994) 28 ATR 344, 352.

⁸ *FCT v Hart* (2004) 55 ATR 712, [43].

⁹ *Taxation Ruling TR 2008/1*.

- (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- (vi) any 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 relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
- (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), 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 relevant taxpayer and any person referred to in subparagraph (vi)

This is perhaps the most relevant requirement for the application of Part IVA to wash sales. Each of these eight factors involves an objective finding of fact and involves determining what a “reasonable person” would conclude.¹⁰ Is it possible for the subjective intentions of the party to be taken into account? In *Peabody* the court found that only an objective conclusion can be drawn having regard to the eight factors in s 177D and that no other matters, including the subjective purpose of any relevant person, can be taken into account in drawing the conclusion.¹¹ This objective approach was confirmed by the High Court in *Spotless*.¹² It is only necessary that one of the parties involved in the scheme have a dominant purpose of obtaining a tax benefit. The consideration of the eight factors listed in s 177D requires a balancing of the commercial and tax elements of a transaction.

B Cumins Case

Although there is no specific legislation covering wash sales the Commissioner gave an indication of his thinking with regard to these arrangements in IT 2643.¹³ This ruling stated that it was not possible to give assurance that Part IVA would not apply to ‘wash sale’ arrangements generally.¹⁴ Perhaps more importantly, the recent decision in the *Cumins* case¹⁵ confirms that the Commissioner is willing to apply Part IVA to wash sales.

In this case the taxpayer was the trustee of a discretionary trust (Trust 1) and that trust derived a capital gain from the sale of shares in 1998. The trust owned other shares which it had purchased with funds borrowed from the National Australia Bank. A wholly owned subsidiary of the bank was appointed attorney to deal with the shares and receive dividends. One day after the above mentioned capital gain was made the taxpayer created a second trust (Trust 2) for which he also acted as trustee. On the same day the taxpayer as trustee of Trust 1 sold the shares to Trust 2 effectively selling them to himself. The sale was effected by an unsigned agreement. Trust 2 did not pay for the shares and the bank was not informed of the sale. The sale resulted in a capital loss for Trust 1 which exceeded the capital gain made the day before. The net capital gain of the Trust for the income year that was distributed to the applicant was reduced from \$939 099 to \$139 099.¹⁶

¹⁰ *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404, 422.

¹¹ *Peabody v FCT* (1993) 40 FCR 531, 542.

¹² *FCT v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404, 413-414.

¹³ *Taxation Ruling No IT2643* covered the sale of shares in companies in liquidation or receivership and has since been withdrawn.

¹⁴ *Ibid* [3].

¹⁵ *Cumins v Commissioner of Taxation* (2007) 66 ATR 57.

¹⁶ *Ibid* [23].

The issues before the court included whether, in the year of income, the applicant in his capacity as trustee of Trust 1 had incurred a capital loss in the sum of \$800 000 under Pt 3-1 (ITAA 1997) and, if so, whether Part IVA (ITAA1936) operated to deem that no part of the capital loss had been incurred.¹⁷ The Tribunal found that the appellant had obtained a tax benefit connected to the scheme identified by the respondent and that a reasonable person would conclude that the sole purpose of the appellant in carrying out the scheme was to obtain the tax benefit and affirmed the respondent's Part IVA determination.¹⁸ Justice Nicholson held that Part IVA may apply even where a scheme is 'genuine or directed at crystallising a loss'; although he noted that in this case no economic loss was suffered and the beneficial ownership of the shares did not change.¹⁹ The *Cumins* case has obvious implications for the use of wash sales. However, the transaction involved exactly the same shares, occurred one day after the capital gain was made, and was not an actual sale of shares on the open market.

C New Ruling

In 2007 the Commissioner issued Draft Taxation Ruling TR 2007/D7 on the application of Part IVA to 'wash sales' arrangements. This Draft Ruling became Taxation Ruling TR 2008/1 on 16 January 2008. The ruling states that the Commissioner is

concerned with arrangements which have the effect of causing a disposition to happen which enables a taxpayer to incur a loss to offset against a gain already derived, or expected to be derived, in certain circumstances. These being where owing to the manner, substance and timing of the events it may be questioned whether the loss making event is mainly to be explained by reference to the purpose of obtaining a tax benefit from the loss.²⁰

The ruling goes on to list nine examples of when a transaction may be considered a wash sale. These examples cover the sale/repurchase of assets including shares, derivatives and financial instruments. They also cover disposing of assets to a company or trust where the taxpayer controls or influences the company or trust or to family members. The ruling covers taxpayers who obtain a benefit in the form of a capital loss or an allowable deduction (where the asset is on a revenue account). Should Part IVA be found to apply to the wash sale the Commissioner is likely to exercise his powers under section 177F to cancel the tax benefit and determine that the whole or part of the capital loss or allowable deduction was not incurred by the taxpayer during the income year.²¹ The ruling then lists six detailed examples applying the eight factors in section 177D to each example. In four of the six examples the conclusion reached is that the Commissioner is likely to find that Part IVA will apply.

¹⁷ *Ibid* [15].

¹⁸ *Ibid* [25].

¹⁹ *Cumins v FCT* (2006) 61 ATR 625, [36-37].

²⁰ *Taxation Ruling TR 2008/1*, [2].

²¹ *Taxation Ruling TR 2008/1*, [14].

IV THE PROBLEM FOR TAXPAYERS AND ADVISORS

A Part IVA

One of the main problems for taxpayers in applying Part IVA is that it does not specifically tell them what the law is with regard to particular transactions but if the transaction is found to be covered by Part IVA then there are penalties involved²². It is drafted so widely that it provides little guidance on whether the Commissioner will apply the Part in particular situations or not. The Courts have also generally failed to provide clear or predictable guidelines to help taxpayers and advisors identify what should be caught by Part IVA.²³ Some researchers have even suggested that General Anti-Avoidance Rules breach the rule of law. Prebble and Prebble believe the rule of law requires that laws be capable of guiding people.²⁴ They must be relatively clear and certain so that people know what is permitted and what is not. General Anti-Avoidance Rules breach this requirement of certainty through their purposeful vagueness.

Perhaps the most difficult aspect of applying Part IVA to wash sales for taxpayers is the “dominant purpose” test. For the Commissioner to conclude there was a “dominant purpose” of obtaining a tax benefit and therefore apply Part IVA to a scheme it is only necessary to apply an objective test using the eight factors listed in s 177D. Sometimes this “dominant purpose” may be obvious in an objective test by a “reasonable person” (such as when there is a simultaneous sell/repurchase transaction of exactly the same security). However, when a period of time has elapsed between the sale and repurchase or when the repurchase involves an asset that is not identical to the original then the dominant purpose may not be as obvious. A taxpayer may have many reasons for repurchasing the same or similar assets after a period of time has elapsed. These reasons could be as varied as a change in fortune of the company whose shares are involved to the advice of an informed family member. For any of these reasons to be taken into account there must be objective evidence (such as the release of improved profit figures) for Part IVA to be found not to apply. Any evidence of the subjective purpose of the taxpayer is irrelevant. This has been concluded in several cases including *FCT v Zoffanies Pty Ltd* where Hill J said:²⁵

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.

This was again confirmed in *Hart* where their Honours found that statements about why the taxpayers acted as they did do not provide an answer to the question posed in s 177D. They found that the section does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others.²⁶ A taxpayer may feel they

²² *Taxation Administration Act, 1953*, Subdivision 284C.

²³ G. T. Pagone QC, ‘Tax Planning or Tax Avoidance’ (2000) 29 *Australian Tax Review*, 96.

²⁴ Rebecca Prebble and John Prebble, ‘Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach the Rule of Law?’ (Paper presented at the Australian Tax Teachers’ Association Conference, Brisbane, 22-24 January, 2007), 2.

²⁵ *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236, [53].

²⁶ *FCT v Hart* (2004) 55 ATR 712.

have a valid reason (other than instigating a wash sale) for repurchasing an asset but unless they can provide objective proof of the reason the Commissioner may still determine that Part IVA applies.

B Taxation Ruling TR 2008/1

The ruling is based on Part IVA so the problems already discussed that relate to this part of the legislation also apply to the ruling. The ruling, however, has problems of its own. Tax rulings are issued by the Commissioner to assist taxpayers and practitioners to apply the tax laws and to fulfill their tax obligations. They provide his opinion as to the interpretation and application of the law and are used by the ATO in fulfilling its role as tax administrator. Two key objectives of the ruling system are to provide certainty and to ensure fairness for taxpayers within the context of the self assessment system.²⁷ The ruling system is therefore meant to provide certainty as to the Commissioner's view of the law and would hopefully put taxpayers and advisors in a position of being clear on how the Commissioner will apply the law to particular situations.

It is in this regard the draft ruling falls short especially concerning its vagueness and lack of "definitions". The ruling could be relevant to any taxpayer who has sold an asset during the year and is contemplating buying some other asset with the proceeds. These taxpayers are offered little "certainty" due to the broad range covered by the terminology used in the ruling. One term which is likely to cause problems appears in the examples of what will be likely to constitute a wash sale. The examples use the term "shortly prior to, at the time of, or shortly after" to describe the time period between the buying and selling of the asset in question.²⁸ The meaning of the term "at the time of" is not considered vague but questions could be raised as to what constitutes "shortly prior to" and "shortly after". Obviously other factors are taken into account when deciding if Part IVA will apply but these terms offer little guidance to taxpayers as to what time frame the Commissioner considers is relevant. If a taxpayer sold shares and bought them back the same day or even within a week a "reasonable person" may consider that to be "shortly after" but what if the taxpayer waits a month, two months or even six months. Will this period of time still be considered "shortly after"?

The detailed examples in the ruling provide little guidance in this respect. One example uses a 24 hour period between the sale and repurchase and states that the price of the stock changed by 1 c during this period – the conclusion being that Part IVA would apply.²⁹ Another example concerns an investor selling shares which are very "volatile" and have gone into "free fall". Three days later he repurchases the shares which have regained some of their credibility and are climbing in price. The overall conclusion is that Part IVA would not apply.³⁰ These two examples are extreme examples and provide little guidance on the period of time the Commissioner would consider to be "shortly" before or after. Although three days is a short period of time, the finding in the second example was due to the change in fortune of the shares and the conclusion as to dominant purpose and had nothing to do with the time period.

²⁷ Diana Scolaro, "Tax Rulings: Opinion or Law? The Need for an Independent 'Rule Maker'" (2006) 16, *Revenue Law Journal*, 1, 108.

²⁸ *Taxation Ruling TR 2008/1*, [4].

²⁹ *Taxation Ruling TR 2008/1*, [26-34].

³⁰ *Taxation Ruling TR 2008/1*, [61-67].

Appendix One to the ruling offers some further guidance on the matter of timing stating that “A significant period of time between the disposal and acquisition would be consistent with the way in which taxpayers usually hold and realise investments”.³¹ However there is no indication of what constitutes a “significant period of time”.

The second vague term concerns the asset itself. The examples use the term “same or substantially the same asset”³² to describe the asset that is the subject of the wash sale. Again, part of this term, the word “same” is not considered vague. However the term “substantially the same” could be open to various interpretations. The ruling attempts to explain the term in paragraph 6 where it states:

An asset is substantially the same as the asset disposed of or dealt with if it is economically equivalent to or fungible with the original asset. An asset is also substantially the same as the original asset if there are immaterial differences between the two assets, such that in substance the assets are economically equivalent.

The ruling mentions, in the examples, that “derivatives or financial instruments that substantially provide continued exposure to the risks and opportunities of the asset”³³ are considered to be the same asset. However it is not clear exactly what assets would be considered “economically equivalent” or “fungible” to other assets?³⁴ Perhaps more guidance in this regard is needed. In their recent joint submission on the draft ruling,³⁵ the professional bodies also point to this vagueness as a problem. They believe that the inclusion of substantially the same assets and derivatives is inappropriate (given that Cumins³⁶ dealt with the same asset) and likely to be impracticable. They recommend that:

The Draft Ruling should provide examples that clarify when an asset will be treated as substantially the same as another. The degree of similarity that is required should be better illustrated. This will be an important issue for investors that may be switching between similar types of investments.³⁷

The actual ruling does attempt to clarify this vagueness slightly compared to the Draft Ruling. The ruling states that shares in a competitor company that carries on a similar business to the original company in question will not constitute substantially the same asset.³⁸ An investor could therefore sell shares in the ANZ Bank and buy Commonwealth Bank shares as these would not be considered substantially the same.

The Commissioner is covering all bases with this ruling by not giving any specific guidance for taxpayers and advisors to follow. The ruling makes generalised statements such as “in the absence of all relevant information, it is not possible to state definitively whether a particular wash sale scheme will attract Part IVA”³⁹ and “An arrangement that achieves similar economic and tax effects through the use of

³¹ *Taxation Ruling TR 2008/1*, [93].

³² *Taxation Ruling TR 2008/1*, [4].

³³ *Taxation Ruling TR 2008/1*, [4].

³⁴ The Macquarie Dictionary defines “fungible” as “of such a nature that one unit or portion may be replaced by another in respect of function, office or use”. So could one bank share be replaced by another bank share or one mining share with another mining share??

³⁵ CPA Australia, the Institute of Chartered Accountants Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia, *Joint Submission on Draft Ruling TR 2007/D7* (2007) <www.taxinstitute.com.au> at 26 September, 2007.

³⁶ *Cumins v Commissioner of Taxation* (2007) 66 ATR 57.

³⁷ CPA Australia, the Institute of Chartered Accountants Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia, see above n 35, 3.

³⁸ *Taxation Ruling TR 2008/1*, [6].

³⁹ *Taxation Ruling TR 2008/1*, [9].

similar techniques to those set out above may also be a wash sale”.⁴⁰ The timing of the release of the ruling, after the Commissioner’s victory in the Cumins case, would seem to indicate that the Commissioner issued the ruling with this case in mind. It is therefore relevant to remember some of the particulars of this case - exactly the same asset was involved (no question of whether it was “substantially the same”), the asset was simply transferred between trusts with no actual change in control or legal ownership, no cash changed hands (it was a paper transaction) and it occurred only one day after a large capital gain was made. Questions should be raised as to whether the ruling is simply addressing this type of mischief or stepping outside the boundaries set in this case.

V SOLUTIONS

A Ruling More Specific

Some of the problems discussed concerning the new ruling could be addressed if the ruling was more specific. More examples are needed to clearly show the Commissioner’s views on what constitutes “shortly” with regard to time and “substantially the same” with regard to the definition of an asset. Of course making the ruling more specific raises a whole new set of problems. The Commissioner issues rulings as a means of expressing his views on particular areas of the law. They are provided to assist taxpayers in light of the self-assessment system. However rulings are not the law.⁴¹ Some would argue that if the Commissioner were to get very specific such as determining an actual set time for “shortly” or compiling a detailed list for “substantially the same” he could be said to be making law and this could be a problem especially if the parameters set are outside the scope of cases such as Cumins. It is not his role to make new laws.

B Specific Legislation

Another possible solution is to legislate specifically against the use of wash sales. The United States has had a “wash sale” provision in the form of section 1091⁴² since 1921. This section provides for the disallowance of the loss on the sale of securities where substantially identical stock has been purchased within thirty days of (before or after) the date of sale. However, perhaps a more relevant comparison can be achieved by considering the legislation in Canada.

Canada has general anti-avoidance legislation similar to Australia. This is contained in Part XVI, section 245 of the Canadian Income Tax Act.⁴³ This section seeks to deny a tax benefit from transactions that are “avoidance transactions”. An avoidance transactions means any transaction (including an arrangement or event) unless the transaction “may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit”.⁴⁴ The section also relates to transactions that are part of a “series of transactions” which would seem to be similar to the Commissioner in Australia being able to identify a part of a transaction as a scheme. Following the Australian experience this section of

⁴⁰ *Taxation Ruling TR 2008/1*, [5].

⁴¹ Scolaro, see above n 27.

⁴² 26 USC Sec 1091

⁴³ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 245.

⁴⁴ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 245 (3) (a).

the legislation would seemingly be considered enough to disallow the use of wash sale transactions however Canada also has specific legislation covering these transactions⁴⁵ and does not simply rely on their anti-avoidance legislation to deter the use of wash sales. Taxpayers cannot recognise a capital loss that is a “superficial loss”, defined in Section 54 as

the taxpayer’s loss from the disposition of a particular property where

(a) during the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer acquires a property (in this definition referred to as the “substituted property”) that is, or is identical to, the particular property, and

(b) at the end of that period, the taxpayer or a person affiliated with the taxpayer owns or had a right to acquire the substituted property.

This section, covering a thirty day period either side of the transaction involving the capital loss, is similar to the US legislation. However, as mentioned above, it is more relevant in Australia’s case as Canada also has anti-avoidance legislation whereas the US does not.

These legislative sections in both Canada and the US provide a clear rule for taxpayers to follow, especially regarding the sale and repurchase of shares in the same company. The effectiveness of legislation that is specific such as this is often brought into question. Although some writers in these countries have suggested “several strategies for dealing with the wash sale rules”,⁴⁶ these strategies do not actually involve buying within the 30 day period either side of the sale. All the “strategies” still involve having to wait the 30 days. In their article “Evaluating the Effectiveness of Code Section 1091 as a Deterrent to Wash Sales”,⁴⁷ Everett and Norton conduct an analysis of ex-post stock price data for 100 firms over a five-year period to determine if sale-repurchase security transactions which fall outside the 30-day wash sale rule could still be potentially profitable. They found that the transactions do tend to produce positive short-term savings. However, they acknowledge that their findings ignore the psychological effects on an investor of such a waiting period. The investor would have to be risk neutral. They even suggest the waiting period could be extended to 60 or 90 days to increase the “risk” faced by investors who attempt this type of transaction. Although this study is now quite dated one would assume that a similar result would be achieved in today’s market.

In a more recent article, Schizer⁴⁸ believes “the wash sale regime of Section 1091 is one of our system’s most important brakes on the timing option.” However, like Everett and Norton, he feels the section does not go quite far enough. The wash sale rules in the US are quite old⁴⁹ and aggressive tax planning using newer types of securities may escape being covered by the rules. The current rules usually do apply when shares are replaced with options. However, some other types of “securities” such as derivatives may not be covered by the current regime. Although this refers to the US legislation it is just as relevant for the Canadian situation as the rules are virtually the same.

⁴⁵ *Income Tax Act*, RSC 1985, (5th Supp), c 1, Section 40(2)(g)(i) and Section 54.

⁴⁶ Leonard J. Lauricella, Year-End Tax Planning: Wash Sales Aren’t Always Bad (2005) <http://taxprof.typepad.com/taxprof_blog/files/2005-25306.pdf> at 28 September 2007.

⁴⁷ John O Everett and Curtis L Norton, ‘Evaluating the Effectiveness of Code Section 1091 as a Deterrent to Wash Sales’ (1981) 16 *The Financial Review*, 3, 4-56.

⁴⁸ David M Schizer, ‘Scrubbing the Wash Sale Rules’ (Working Paper No 242, The Center for Law and Economic Studies, Columbia Law School, 2004) 2.

⁴⁹ Section 1091 was originally enacted in 1921.

The goal of wash sale rules is to discourage tax-motivated sales of securities. This could be achieved in Australia by enacting specific legislation with a specified period during which the wash sale rules would apply. This regime would then burden loss “harvesting” with a non-tax cost: taxpayers have to give up economic exposure to the particular security for a specified period of time. The hope is that this extra “cost” would be so unappealing that taxpayers would choose instead to forgo the loss or at least truly realise a loss and end their economic exposure to the asset.⁵⁰

The introduction of a specific wash sale rule would also help alleviate the vagueness created by the new Ruling and Part IVA. There are many advantages of having specific legislation. A specific rule provides certainty and guidance to taxpayers and advisors. They are able to plan their investment activities with absolute knowledge of the way their actions will be interpreted. A specific rule may also be easier for the ATO to administer as it would be a self-operating provision and administrators could search for transactions that breached the time period set by the specific rule. Part IVA is not a self-operating provision and requires the Commissioner to exercise his discretion on whether to apply Part IVA to a particular transaction.

It is important to recognise that there are disadvantages to such specific rules. One disadvantage of a specific legislative regime is that it would add complexity to the already complicated taxation legislation. However sometimes the addition of a rule which gives specific “black and white” guidance as opposed to general provisions such as Part IVA are advantageous to taxpayers and advisors.

It is commonly believed that the more specific and detailed a system’s rules become, the more ways people will find to circumvent the rules.⁵¹ It is acknowledged that specific legislation would not stop the attempts of some taxpayers to use wash sales. There would still be taxpayers willing to risk the time period and sell shares with the intention of buying them back at the end of the time and those who find some other way around the specific rule. However, even without specific legislation there will always be taxpayers who attempt to “work the system”. One could make sure they sell their shares around the time of the release of annual profit figures. The repurchase of the shares could then be said to have a dominant purpose other than a tax benefit (even if that is not true). It is worth remembering that Part IVA would still exist as an overriding provision and could still be applied to taxpayers who try to circumvent the specific legislation should the Commissioner feel their dominant purpose was that of tax avoidance.

Another disadvantage is that by allocating a specific time in which a sale/repurchase could not take place there is also the possibility that the legislation would block behaviour that is not tax-motivated. A taxpayer may sell a security that they truly no longer want, but then due to a change in circumstances (eg the release of profit figures that show a marked turnaround in performance), may wish to regain ownership of the asset. A specified waiting period would mean the taxpayer could not regain the asset immediately and may have to pay a far greater price when the waiting period expired.

⁵⁰ Schizer, see above n 48.

⁵¹ Prebble and Prebble see above n 24.

VI CONCLUSION

A good tax system should be simple to understand and easy to apply to individual circumstances. The release of the Ruling on the application of Part IVA to wash sale arrangements is vague and broad in terms of the transactions it is attempting to cover. It is not specific with regards to time periods or types of assets involved. Considering the large number of “average” taxpayers such a ruling may affect, this vagueness will lead to uncertainty and concern for many of these taxpayers and their advisors.

The introduction of specific legislation concerning wash sales (similar to that in Canada and the US) would bring more clarity and certainty for the many investors and advisors struggling with the implications of Part IVA and the Ruling. Even though there are those who argue that more legislation makes the tax system more complicated there are some situations where a specific rule adds to the simplicity of the system as far as taxpayers and advisors are concerned. A specific wash sales regime in the legislation, if crafted with care, could add simplicity for taxpayers and advisors compared to the vagueness of the draft ruling, whilst enhancing the efficiency of the realisation-based capital gains regime. The specific regime would still have the overarching principles of the General Anti-Avoidance Rules to deter those who try to circumvent the specific rules. Such a regime needs to be tough enough to reach a point where enough taxpayers are deterred from harvesting losses and clear enough that taxpayers feel confident in following the “rules”.

ROSA'S LAST GASP: THE FINAL STEPS IN SELF ASSESSMENT'S 21 YEAR JOURNEY

MICHAEL DIRKIS AND BRETT BONDFIELD*

Income tax self assessment has operated in Australia for over of 21 years. The introduction of self assessment fundamentally altered the balance of power and focus of responsibilities between taxpayers and the Australian Taxation Office (ATO). It has also impacted dramatically on the triangular relationship between the ATO, taxpayers, and their tax advisers creating an often fractious relationship.

Although there had been some changes in the early 1990's, it was with the release in March 2004 of the discussion paper, Review of Aspects of Income Tax Self Assessment (ROSA) that the Government finally accepted that this imbalance needed redressing. The resultant changes to the penalty regime and interest charge provisions were enacted by Tax Laws Amendment (Improvement of Self Assessment) Act (No 1) 2005 and the Shortfall Interest Charge (Imposition) Act 2005. The changes expanding the scope of the ruling system and the shortening of the periods of review (including nil assessments) were enacted by the Tax Laws Amendment (Improvement of Self Assessment) Act (No 2) 2005.

Since these changes there has been no action on the balance of the ROSA legislative recommendations until the then Minister for Revenue and Assistant Treasurer announced:

- *on 27 March 2007 that the Board of Taxation would consult publicly on the scope to apply consistent self assessment principles across all federally administered taxes;*
- *on 26 June 2007 the release of a discussion paper examining options for reforming liability discretions in the income tax law; and*
- *on 22 August 2007 a review into unlimited amendment periods in the income tax laws and released a discussion paper.*

The focus of this paper is to review the liability discretion and unlimited amendment period Treasury papers to evaluate the effectiveness of the approach adopted in those papers and the likely impact of any reforms upon the self assessment system.

I INTRODUCTION

Income tax self assessment has been in operation in Australia for in excess of 21 years.¹ The move to self assessment was driven by the desire to improve the cost efficiency of revenue collection by liberating assessing resources within the Australian Taxation Office (ATO) to audit activities.²

However, its introduction fundamentally altered the balance of power and focus of responsibilities between taxpayers and the ATO.³ This occurred as taxpayers have had to bear virtually all, or at least a disproportional share of the burden of moving to self assessment. This included dealing with the uncertainty associated with what are often overly complex legislative provisions and the threat of significant penalties and the imposition of the General Interest Charge if their view of laws is not as likely to be correct as incorrect, or is more likely to be correct than incorrect. As a result this has also impacted dramatically on the triangular relationship between the ATO, taxpayers, and their tax advisers⁴ and has created an often fractious relationship.⁵

To redress this imbalance there were some changes in the early 1990's, and in 2005 as a result of the *Review of Aspects of Income Tax Self Assessment (ROSA)*. Some additional minor alterations could be on the horizon as the then Minister for Revenue and Assistant Treasurer announced during 2007 the establishment of three reviews aimed at finalising the ROSA review.

Firstly, this paper undertakes an historical stocktake of the changes to self-assessment since 1986. The paper then focuses on the effectiveness of the approach adopted in two recent Treasury papers and the likely impact of any reforms upon the self assessment system in the context of comments made in the Inspector-General of Taxation's Review into the Tax Office's Administration of Public Binding Advice.⁶

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¹ In September 1985 the Government first announced that traditional taxation administration arrangements were to be replaced with self assessment in National Review of Standards for the Tax Profession Report: *Tax Services for the Public* (1994). Self assessment was introduced in a piecemeal basis, with the first tranche introduced in a limited form in the 1986-87 year and full self assessment for companies and superannuation funds introduced from 1 July 1989. For a brief overview of self assessment see Inspector General of Taxation, Commonwealth, *Issues Paper Number 3: Self-assessment* (December 2003) at URL: http://www.igt.gov.au/content/Issues_Papers/Issues_Paper_3.asp located on 17 November 2007.

² Peter Costello, Treasurer, Commonwealth, *Discussion Paper: Review of Aspects of Income Tax Self Assessment* (March 2004), 3.

³ For an explanation of and background to this shift of responsibility, see *Tax Services for the Public*, above n 1 at 3-9.

⁴ Ibid at p xvii.

⁵ For example, at the ATO Tax Practitioner Forum's (ATPF's) November 2001 meeting, the Taxation Institute raised for discussion numerous practitioner concerns about the increasing volume of tax return information being required in a self assessment environment (Agenda Item 3.10).

⁶ Inspector-General of Taxation, "Inspector-General of Taxation announces terms of Reference for three new reviews", Press Release, 12 October 2007. The Review into the Tax Office's Administration of Public Binding Advice will examine the extent to which the Tax Office has met expectations by making its advice legally binding for a wider range of topics, while balancing appropriate risk management considerations with the aim of improving certainty. It will also examine the relationship between concepts such as "general administrative practice" "general guidance" and "legally binding advice". For a copy of the paper go to:

The paper will conclude by evaluating whether the power balance been taxpayers and the ATO has been or will be achieved in the context of ROSA's last gasp.

II HISTORY

A September 1985: The start of self assessment

The Government first announced in September 1985 that traditional taxation administration arrangements were to be replaced with self assessment.⁷ The decision to adopt a self assessment regime reflected the reality of the administration of the full assessment system in the mid 1980's. Under the traditional assessment system the returns lodged were supposed to be reviewed and examined by the ATO before tax was calculated and an assessment issued. This process had degenerated to lip service in many ATO branches with assessors being asked to process 1,000 individual returns in a standard seven hour, twenty one minute day.⁸ The excessive person power requirements of the system coupled with lack of quality assurance meant the old system could not last.⁹ Thus, given that under full self assessment there is, in most instances, no checking of the return prior to assessment, the cost savings by the revenue authorities alone would be enough to push a Government to adopt a self assessment system.¹⁰

Despite the economic imperatives, self assessment has been introduced in Australia on a piecemeal basis. Initially, a minimalist self assessment system was introduced on 1 July 1986.¹¹ This introduction, in the absence of a binding ruling system, created concerns about uncertainty and about the resultant penalties and interest charges that could result from a taxpayer making a mistake.¹² In order to support the self assessment system, taxpayers need a mechanism for gauging the Commissioner's view of a tax matter. They also need to be certain that if that transaction is undertaken in accordance with ATO advice, it is free from subsequent challenge by the ATO. Although the Commissioner had issued Public Rulings since 1982, these rulings were not binding and indeed the Commissioner has publicly argued against these old rulings in litigation.¹³

http://www.igt.gov.au/content/work_program/071012_Binding_advice_FINAL%20.pdf located on 17 November 2007.

⁷ *Tax Services for the Public*, above n 1.

⁸ The average salary and wage return received one minute scrutiny, the average business return four minutes – see *2004 ROSA Discussion Paper*, above n 2, 2.

⁹ See generally Michael Dirkis and Michael Payne-Mulcahy, "Time for a change: Self assessment 14 years on" (2002) 36 *Taxation in Australia* 417.

¹⁰ Under self assessment taxpayers' returns are lodged (either in a paper form or electronically), the lodging of a return is deemed to be an assessment. The ATO does not review the returns on lodgement. The taxpayer has the responsibility for calculating the amount of tax due and payable imposed and is required to calculate the tax and lodge a cheque with the return if tax is payable. A notice may be issued by the ATO confirming the amount paid (or a refund is issued where appropriate).

¹¹ See "What the Commissioner said: desk Audit – Self Assessment" (1986) 21 *Taxation in Australia* 255.

¹² See PL Williams "President's Page" (1988) 23 *Taxation in Australia* 265 and Jeff Mann "The President's Page – Looking forward to a year of challenge" (1990-91) 25 *Taxation in Australia* 523.

¹³ See *Bellinz Pty Ltd v FCT* (1998) 39 ATR 198. The limited scope of these rulings was the problem.

In response to these concerns the then Treasurer announced in a "Simplification Statement" on 13 December 1990 that the Government was to make changes.¹⁴ After a consultative document of 13 December 1990¹⁵ and an information paper on 20 August 1991,¹⁶ the modifications required to improve the self assessment system were introduced in 1992. This involved the introduction of the binding rulings system, a new interest system for under payment or late payment of tax, adjustments to the amendment process¹⁷ and the objection period¹⁸ and a new penalties regime.¹⁹

*B Commonwealth Parliament's Joint Committee of Public Accounts: Report No 326
November 1993*

Following the introduction of these changes the Commonwealth Parliament's Joint Committee of Public Accounts (JCPA) conducted an inquiry into the ATO's operations. In November 1993 the JCPA handed down its *Report No 326 - An Assessment of Tax - A Report on an Inquiry into the Australian Taxation Office* (Report 326). The JCPA recommended 148 changes to various areas of taxation administration and legislation.²⁰

The JCPA saw an urgent need for a review of the responsibilities and practical obligations of the self assessment system for taxpayers and their agents. It noted a need for increased support to assist taxpayers to satisfy their obligations.²¹ It recommended both: a delay in further extension of the self assessment system (pending the development of a comprehensive supporting legislative framework); and that the ATO make taxpayers more aware of their obligations under self assessment.²²

The JCPA also saw a need to reform the rulings system to fundamentally re-evaluate the roles of the administrator and the legislator. It considered that the costs of access to judicial interpretation had effectively transferred the power to define the law to the Commissioner.²³ It noted "[i]n no circumstances should an administrator have the capacity to impose on citizens obligations which cannot be supported clearly in the law".²⁴ The JCPA in particular recommended that:

- all public Rulings should acknowledge any alternative legal interpretations, and should not be issued where varying interpretations cast serious doubt on the validity of the Ruling;
- all public Rulings go through a formal approval process;
- a notice identifying and summarizing a public Ruling should be placed in the Commonwealth Gazette in order to clarify it is a public Ruling;

¹⁴ See "Income Tax simplification the first instalment" (1990-91) 25 *Taxation in Australia* 557.

¹⁵ Paul J Keating, Treasurer, Commonwealth, *A full self assessment system of taxation: A consultative document* (13 December 1990).

¹⁶ John Kerin, Treasurer, Commonwealth, *Improvements to self assessment - Priority tasks: An Information Paper* (20 August 1991).

¹⁷ The Commissioner was permitted to rely on statements made in an amendment request.

¹⁸ The period to object to an assessment or private Ruling was set at 4 years.

¹⁹ *Taxation Laws Amendment (Self Assessment) Act 1992*.

²⁰ Joint Committee of Public Accounts, *Report No 326 - An Assessment of Tax - A Report on an Inquiry into the Australian Taxation Office* (1993). For a summary of its recommendations see Michael Dirkis, "Australia: The times they are a changing: Tax Reform in 1993/94" (1994) 48 *Bulletin for International Fiscal Documentation* 492.

²¹ *Report No 326*, *ibid*, xix.

²² *Ibid*, recommendations 19 & 20; also see paras. 6.32-6.36.

²³ *Ibid*, xx.

²⁴ *Ibid*.

- Parliament, as the only body with the power to make laws should have a supervisory role in respect of all public Rulings (i.e. public Rulings should be tabled in Parliament within five days of Gazettal, allowing the Parliament to evaluate and analyse them, and respond to unsatisfactory rulings);
- the Commissioner should review all the ATO's Determinations and public and private Rulings to determine their continued validity;
- where a taxpayer indicates in a return that they are not following a private Ruling, no penalties should be applied or where a Determination is ignored;
- hypotheticals should be ruled upon, resources permitting; and
- the ATO create a publicly available computer data base of all private Rulings and the public register consolidating all Determinations, and public and private Rulings.²⁵

In respect of administratively imposed penalties the JCPA recommended that the Commissioner's power to administratively impose culpability penalties be removed as culpability should be settled by the courts not administrators.²⁶ The JCPA conceded that if these powers are retained, penalties should be imposed by a legally qualified officer. It also recommended that the law be amended to stop the re-imposition of a penalty where a prosecution is withdrawn.²⁷

Despite the JCPA's concerns about the continuing inequity of the self assessment system the Government largely ignored its recommendations.²⁸ They accepted the JCPA's recommendations concerning the Gazettal of public Rulings and that all public Rulings should be tabled in Parliament within five days of Gazettal. However, they did not agree that Rulings would not be subject to disallowance by the Parliament. The Government also rejected the recommendations that penalties should not be imposed where a taxpayer indicates in a return that they are not following a private Ruling or where a taxpayer ignores a Determination. Also it did not support the imposition of limitations on the Commissioner's powers to impose penalties. To deal with the recommendation that Rulings should be vetted by senior staff, the Commissioner announced the formation of a panel to review major rulings, consisting of three senior ATO staff and two external members.

*C Two large tax reform initiatives:
1998 A new tax system and 1999 Review of Business Taxation*

Recommendations for the reform of the rulings and amendment period aspects of self assessment were contained in the Government's August 1998²⁹ blue print for tax reform, *Tax Reform, Not a new tax, a new tax system* (the ANTS document).³⁰ The ANTS document indicated that the Government would:

²⁵ Ibid, recommendations 28-43; also see paras. 6.15-6.98.

²⁶ Ibid, xx.

²⁷ Former s 82E(2) (and its successor s 284-90(1) item 8) of the *Taxation Administration Act 1953*.

²⁸ See Treasurer, *Response to "Report No 326 - An Assessment of Tax - A Report on an Inquiry into the Australian Taxation Office"* (9 August 1994).

²⁹ Treasurer, "A New Tax System for all Australians", Press Release No 79, 13 August 1998.

³⁰ See generally Peter Costello, Commonwealth, *Tax Reform, Not a new tax, a new tax system* (August 1998). For a summary of this reform process see John Harrison, "The GST Debate-A Chronology: Background Paper No 1 1997-98" (1997) (updated by Marilyn Stretton (1999) at URL: <http://www.aph.gov.au/library/pubs/chron/1998-99/99chr01.htm> located on 13 November 2007.

- reduce uncertainty and compliance costs by reducing from four to two years the period in which the ATO can amend assessments of wage and salary earners;³¹
- make oral advice on simple tax issues binding on the Commissioner;
- ensure that the ATO rulings system is made more comprehensive and its scope is more certain by allowing the Commissioner to give a ruling on procedural, administrative or collection matters and on a question of fact; and
- examine a system of user charges for private rulings and other binding advice given to large business taxpayers in complex cases.

None of these suggestions were implemented by 1999, when the Review of Business Taxation (RBT or Ralph Committee) released its final report, *A Tax System Redesigned*,³² which also made some recommendations in relation to self assessment.

The recommendations were to:

- Expand the scope of legally binding rulings;³³
- Improve certainty and timeliness of private rulings;³⁴
- Not introduce a "class order" private rulings system;³⁵
- Have the same penalty regime for public and private rulings;³⁶
- Introduce a fee for selected rulings; and³⁷
- Have rulings remain a function of the ATO.³⁸

Initially the Government did not specifically respond to these recommendations. It did, however, rewrite the penalty regime.³⁹

31 An unlimited period would continue to apply in cases of fraud or evasion.

32 Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999).

33 *A Tax System Redesigned*, *ibid*, recommendation 3.1. This was originally an ANTS recommendation. The Government did not directly respond to the recommendation. The initiative was finally adopted through ROSA.

34 *A Tax System Redesigned*, *ibid*, recommendation 3.2. The Recommendation consisted of four issues: default issue of private rulings; use of facts from other sources; taxpayer to bring new evidence; and public information on ATO technical decisions. Initially there was no specific response. Finally, only the last issue was put into practice by the ATO in the form of "Register of Private Binding Rulings". Edited private Rulings are in general published in the Register only if they were applied for after 31 March 2001: PS LA 2001/7 paragraph 3. For details of the new practice; see ATO's PS LA 2001/7. This change was not a direct result of the Ralph Recommendation. It came from a separate internal review of the private ruling system commissioned by the Commissioner in May 2000. For details of the review, see *Report of an Internal Review of the Systems and Procedures relating to Private Binding Rulings and Advance Opinions in the Australian Taxation Office* (commonly known as the Sherman Report), issued on 7 August 2000.

35 *A Tax System Redesigned*, *ibid*, recommendation 3.3. No action was required.

36 *A Tax System Redesigned*, *ibid*, recommendation 3.4. The Government did not directly respond to the recommendation. As a result of ROSA, the Treasurer announced that the differential penalty for disregard of private rulings in s 284-90(1)(item 8) of the *Taxation Administration Act 1953* would be abolished (see Treasurer, "Outcome of the Review of Aspects of Income Tax Self Assessment", Press Release No 106, 16 December 2004, Recommendation 38). Section 284-90(1)(item 8) of the *Taxation Administration Act 1953* was repealed by the *Tax Laws Amendment (Improvement of Self Assessment Act (No 1) 2005* for the 2004-2005 income year.

37 *A Tax System Redesigned*, *ibid*, recommendation 3.5. This was originally an ANTS recommendation. The Government did not directly respond to the recommendation.

38 *A Tax System Redesigned*, *ibid*, recommendation 3.6. No action was required.

39 The legislation is contained in *A New Tax System (Tax Administration) Act (No 2) 2000*. However, the rewrite ignored *A Tax System Redesigned*, *ibid*, recommendation 3.4 to remove the imposition of additional penalties where a taxpayer declines to follow an adverse private Ruling or Determination by rewriting as s 284-90(1) item 8.

D Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: 2001

Despite the Report 326, ANTS and the Review of Business Taxation recommendations little was actually done to address the taxpayer/ATO power imbalance. This imbalance was in evidence given by taxpayers to the 2001 Senate Economics Reference Committee's *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection*.⁴⁰ This evidence pointed to the continuing public misconceptions of the self assessment system. On this issue the Committee recommended:

. . . that the ATO, in consultation with the Taxation Institute of Australia, the Commonwealth Ombudsman and other relevant bodies, develop measures to educate taxpayers about their obligations and rights in the self assessment environment. Particular attention should be given to ensuring that taxpayers are made aware of the period over which the ATO may review their returns and amend their assessments. Further . . . information about the ATO's power to review and amend assessments, and the time periods that apply, should be clearly stated in the *TaxPack* and on notices of assessment sent to taxpayers.⁴¹

E Review of Income Tax Self-assessment (ROSA): 2004

On 24 November 2003, the Treasurer announced a major Review of Income Tax Self-assessment (ROSA) to be conducted by a Treasury taskforce that included officers seconded from the ATO.⁴² The review of the income tax self assessment system focused on whether the right balance has been struck between protecting the rights of individual taxpayers and protecting the revenue for the benefit of the whole Australian community. The Government in March 2004 released the discussion paper, *Review of Aspects of Income Tax Self Assessment (ROSA)*.⁴³ The discussion paper sought feedback on different options for addressing these issues, including:

- making more of the ATO's advice legally binding;
- shortening the period in which the ATO could amend assessments;
- introducing a time limit for the ATO to advise taxpayers that their assessments may be reviewed and therefore could ultimately be subject to amendment; and
- reducing the General Interest Charge where assessments were amended to increase tax payable.

⁴⁰ On 29 June 2000 the Senate referred to the Senate Economics Reference Committee the matter of mass marketed tax effective schemes and investor protection for inquiry and report with particular attention to:

- The adequacy of measures to promote investor understanding of the financial and taxation implications of tax effective schemes;
- The conduct of, and the adequacy of measures for controlling, tax effective scheme designers, promoters and financial advisers; and
- The ATO's approach towards and role in relation to mass marketed tax effective schemes.

For examples of the imbalance see - Taxation Institute of Australia's 27 August 2001 submission to the Senate Economics Reference Committee's *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection*.

⁴¹ Senate Economics Reference Committee, Commonwealth Parliament, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection* (11 February 2002), xiii, recommendation 3.36

⁴² Treasurer, "Review of Aspects of Income Tax Self-Assessment", Press Release No 98, 24 November 2003.

⁴³ See Treasurer, "Release of discussion paper on the income tax self assessment system", Press Release No 17, 29 March 2004 and *2004 ROSA Discussion Paper*, above n 2.

After a period of consultation Treasury submitted its recommendations to the Government in August 2004.⁴⁴ A number of the recommendations can be traced to Report 326, ANTS and the Review of Business Taxation.⁴⁵ In December 2004 the Government accepted the 54 recommendations (30 requiring legislative reform and 24 that are administrative in nature).⁴⁶ Of the recommendations requiring legislation, 29 required some consequential administrative changes by the ATO as did 17 of 24 administrative recommendations.⁴⁷ The balance of the administrative recommendations was to be implemented by: Treasury (4); the Inspector-General of Taxation (2); and the Board of Taxation in conjunction with Treasury (1).

The legislative changes to the penalty regime and interest charge provisions (introduction of the Shortfall Interest Charge) were enacted by *Tax Laws Amendment (Improvement of Self Assessment Act (No 1) 2005* and the *Shortfall Interest Charge (Imposition) Act 2005*.⁴⁸ These changes were aimed at taxpayers whose assessments were amended to increase a liability. They created the Shortfall Interest Charge to replace the then existing General Interest Charge with a charge four percentage points lower than the General Interest Charge rate.

These changes impacted on entities who received an administrative penalty for a shortfall amount, given they were operating in a self assessing environment. The changes recognised that, in pre-amendment 'shortfall' cases, taxpayers are usually unaware of their debts, and so are unable to respond to the incentive premium of the General Interest Charge to pay their debts on time. The measure introduced a new, lower Shortfall Interest Charge in lieu of the General Interest Charge for the period before assessments are amended. This measure also allowed for the Commissioner to remit the Shortfall Interest Charge where the Commissioner considered it fair and reasonable to do so.

As well the measure amended the law to provide that when an administrative penalty applies and the Commissioner decides the penalty should not be remitted in full, the Commissioner must provide the taxpayer with an explanation of why the penalty applies and why it has not been remitted in full.

The changes to expand to the scope of the ruling system and the shortening of the periods of review (including nil assessments) were enacted by the *Tax Laws Amendment (Improvement of Self Assessment Act (No 2) 2005*.⁴⁹ A standard amendment period of two years for taxpayers with simple affairs, including most individuals and very small business taxpayers was implemented.

The amendment period for other taxpayers, such as taxpayers with complex affairs and large businesses, generally remained at four years. The amendment period for loss and nil liability returns was made the same as for a return incurring a positive liability. The amendment period for assessments where a taxpayer sought a scheme benefit in

⁴⁴ Treasury, *Report on Aspects of Income Tax Self Assessment*, (August 2004).

⁴⁵ For example, ROSA recommendation 4.3 adopts *Report No 326* recommendation 37 and the *A Tax System Redesigned* recommendation 3.4; ROSA recommendation 3.1 adopts ANTS recommendation for reducing from four to two years the period in which the ATO can amend assessments of wage and salary earners and ROSA recommendation 2.2 adopts ANTS recommendation for expanding the scope of legally binding rulings and the *A Tax System Redesigned* recommendation 3.1.

⁴⁶ Treasurer, "Outcome of the Review of Aspects of Income Tax Self Assessment", Press Release No 106, 16 December 2004.

⁴⁷ See Australian Taxation Office, "Review of Aspects of Income Self Assessment (ROSA): Briefing to National Tax Liaison Group" - June 2005.

⁴⁸ Received Royal Assent on 29 June 2005.

⁴⁹ Received Royal Assent on 19 December 2005.

relation to income tax (including where Part IVA of the *Income Tax Assessment Act 1936* (ITAA36) is invoked) was set at four years. The unlimited amendment period for cases of fraud or evasion was not changed.

The rulings system changes were intended to improve ways for taxpayers to access timely determinations on how certain laws apply, so that the risks of uncertainty when self assessing, or working out their tax obligations or entitlements, were reduced. The changes were to:

- make rulings available to many taxpayers on a wide range of matters;
- ensure that the Commissioner provides rulings in a timely manner;
- enable the Commissioner to obtain, and make rulings based on, relevant information;
- protect taxpayers from increases in tax and from penalties and interest where they rely on rulings;
- limit the ways the Commissioner can alter rulings to a taxpayer's detriment; and
- give protection from interest charges where a taxpayer relies on other advice from the Commissioner, or on the Commissioner's general administrative practice.⁵⁰

The ATO claims to have implemented 10 of the administrative changes with further recommendations scheduled for finalisation by the end of March 2008.⁵¹ ATO follow-up on recommendations requiring a legislative response has been completed for 23 recommendations with work relating to the remaining six recommendations scheduled for finalisation by the end of May 2008.⁵²

The recommendation to the Board of Taxation for a review of consultation has been finalised with the Government accepting the recommendations of the Board set out in February 2007 in *Improving Australia's Tax Consultation System — A Report to the Treasurer*⁵³ on 16 August 2007.⁵⁴ The Inspector General of Taxation has also completed his two ROSA reviews, i.e. in respect of the ATO's Test Case Litigation Program⁵⁵ and whether there is a pro-revenue bias in Private Binding Rulings.⁵⁶

⁵⁰ Explanatory Memorandum *Tax Laws Amendment (Improvement of Self Assessment Bill (No 2) 2005*, Summary of Regulation Impact Statement.

⁵¹ "ROSA NTLG Briefing as 29 May 2007", in NTLG Draft Minutes for the meeting of 28 June 2007.

⁵² "ROSA NTLG Briefing as 15 August 2007", in NTLG Draft Minutes for the meeting of 5 September 2007. Update: There has not been official advice of the status of these six matters but informal advice indicates they are considered as being achieved through administrative action.

⁵³ Board of Taxation, *Improving Australia's Tax Consultation System — A Report to the Treasurer* (February 2007).

⁵⁴ Treasurer, "Improving Australia's Tax Consultation System: Report by the Board of Taxation", Press Release No 76, 16 August 2007.

⁵⁵ The review was part of Inspector General of Taxation, *Review of Tax Office Management of Part IVC litigation* (28 April 2006). The report was publicly released on 7 August 2006.

⁵⁶ Inspector General of Taxation, *Review of the Potential Revenue Bias in Private Binding Rulings Involving Large Complex Matters* (16 December 2007). The Review commenced on 25 August 2005.

F Current initiatives

On the matters referred to Treasury, since the 2005 legislative changes, there had been no action until the then Minister for Revenue and Assistant Treasurer announced:

- on 27 March 2007 that the Board of Taxation would consult publicly on the scope to apply consistent self assessment principles across all federally administered taxes;⁵⁷
- on 26 June 2007 the release of a discussion paper examining options for reforming liability discretions in the income tax law;⁵⁸ and
- on 22 August 2007 a review into unlimited amendment periods in the income tax laws and released a discussion paper.⁵⁹

It is the scope of these reviews which is the focus of the next section of the paper.

III EVALUATING THE 2007 REVIEWS

The Board of Taxation's terms of reference in respect of its consultation on the scope to apply consistent self assessment principles across all federally administered taxes will be considered. Then the paper evaluates the Treasury discussion papers that examine options for reforming liability discretions in the income tax law and review unlimited amendment periods in the income tax laws respectively.

A Board of Taxation review of consistent self assessment principles across all federally administered taxes

The Board of Taxation has commenced a process of public consultation on the scope to apply consistent self assessment principles across all federally administered taxes (including the Goods and Services Tax [GST]).⁶⁰

The Board's terms of reference are:

- Extending the framework for legally binding rulings that currently applies to income tax and numerous other taxes to the GST and other taxes for which the Commissioner of Taxation has administrative responsibility. The goal of a single regime for rulings is considered worth pursuing for the potential benefits for practitioners and taxpayers who interact with several aspects of the tax system;

⁵⁷ Minister for Revenue and Assistant Treasurer, "Board of Taxation to Consult on Opportunities to Apply Consistent Self Assessment Principles Across All Taxes", Press Release No 26, 27 March 2007.

⁵⁸ Minister for Revenue and Assistant Treasurer, "Review of Discretions in the Income Tax Law", Press Release No 76, 26 June 2007 and Treasury, *Review of Discretions in the Income Tax Laws - Discussion Paper* (June 2007). Following ROSA recommendation 6.3, the discussion paper proposes a methodology to replace the discretions with objective tests that a taxpayer can apply when they lodge their tax return.

⁵⁹ Minister for Revenue and Assistant Treasurer, "Review of unlimited amendment periods in the income tax laws", Press Release No 103, 22 August 2007 and Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws - Discussion Paper* (August 2007).

⁶⁰ Board of Taxation "Consultation on the Application of Consistent Self Assessment Principles" at URL: http://www.taxboard.gov.au/content/self_assessment_principles.asp accessed on 7 December. As at this date this is the only detailed material on the Board's website regarding this matter.

- Applying the principle that amendment periods should approach the minimum required for the Tax Office to identify incorrect assessments and take action to correct them. Recent changes to income tax legislation reduced amendment periods for individuals and small businesses to two years.
- Applying the Shortfall Interest Charge, rather than the General Interest Charge, to cases where there is a shortfall of tax (in taxes other than income tax).⁶¹

In considering these terms of reference the Board has been asked to consider issues of symmetry between taxpayers. However, in respect of symmetry between the ATO and the taxpayer, the second point of the terms of reference simply refers to consistent and minimised amendment periods. This approach merely reinforces a view (which is discussed in more detail in respect of the Treasury discussion paper on unlimited amendment periods in the income tax laws at point C following) that the ATO/Taxpayer symmetry is too often viewed through a compliance-integrity prism. This viewpoint seems to focus on certainty for the taxpayer by giving the ATO limited but sufficient time to discover non-compliance. This is to be contrasted with giving the taxpayer ample time to discover 'non-compliance' that has resulted in too much tax being paid.

It is important to note that the Board of Taxation is seeking a consistent approach in all laws administered by the ATO. Concern has been expressed for many years of inconsistencies in the self assessment model as it operates for different taxes, in particular the *Fringe Benefits Tax Assessment Act 1986*.⁶²

Moreover there has been a consistent view expressed by peak tax professional bodies of the need to move to a single rulings model across Commonwealth taxes. This view has been consistently expressed for nearly a decade.⁶³ This need for consistency in the rulings process is all the more important because the ATO has an expanded remit with a responsibility for the administration of superannuation.

⁶¹ Ibid.

⁶² The self assessment system was applied in respect of Fringe Benefits Tax (FBT) at the same time as income tax and, unlike income tax, it was not subjected to subsequent review. As a result the self assessment process in respect of FBT still contains some crucial legislative defects. For example, there are inconsistencies between s 74(3) and s 72 of the *Fringe Benefits Tax Assessment Act 1986*. While s 74(3) still embodies the concept of "full and true disclosure" in the making of an assessment, s 72 deems the making of an assessment when the taxpayer lodges his return. This inconsistency raises the issue as to how can a full and true disclosure can be made when returns are in the main lodged electronically. The effect of this inconsistency is that the period for amendment is effectively always six years rather than the intended three year period.

⁶³ The Taxation Institute has been concerned since 1999 about the inconsistency between the ruling processes between income tax and the GST. To this end the Taxation Institute wrote to the then Treasurer on 26 August 1999 in support of the creation of a single statutory rulings system and on 14 October 1999 to the then Assistant Treasurer, Senator Rod Kemp addressing a number of issues and problems arising from GST rulings. These concerns were also expressed in a February 2000 confidential joint Taxation Institute, ICAA, CPA and Law Council submission to the ATO as well as providing comments on the recommendations on rulings contained in *A Tax System Redesigned*. The submission followed a meeting on 18 January 2000 between the ATO and these professional bodies, in which a case was made for the incorporation of GST into one formal rulings system. The Taxation Institute reinforced its view in its 28 May 2004 submission to the Treasury in response to the discussion paper - *Review of aspects of Income Tax Self Assessment* - in which the covering letter addresses the need to consider a standardised ruling system for both income tax and indirect taxes.

B *Review of Discretions in the Income Tax Laws – Discussion Paper*

The intention of the Review of Discretions Discussion Paper⁶⁴ is to simplify the nature and number of discretions that are available to the Commissioner under the taxation law. The Treasury paper takes a principles based approach by trying to identify overarching concerns and policy considerations to be taken into account when assessing the appropriate response to an identified discretion.⁶⁵ The paper undertakes a considerable exercise of identification and classification, as well as providing a useful working definition of discretions and their effect as:⁶⁶

[P]rovisions in the law that are not self-operating, so that the outcome depends on the Commissioner forming an opinion, attaining a state of mind, making a determination, exercising a power or refusing to do any of the above. The potential for uncertainty caused by discretions was first identified in 1991 in the government information paper, *Improvements to Self Assessment – Priority Tasks*. This paper noted that some discretions made it difficult for ‘taxpayers [to] know the consequences of transactions at the time they are undertaken.’⁶⁷

The thrust of the Discussion Paper is to circumscribe and minimise the role of discretion. The major stated benefit of doing so is to increase taxpayer certainty. It is argued that the taxpayer will be in a position to determine their liability because there is less scope for the Commissioner to ‘subjectively’ decide matters that will impact on that liability. It must be kept in mind that this is a self selected goal of the reduction of discretion. As will be argued later, certainty is not the same thing as fairness. Less discretion, of whatever sort, may make for a more rigid system incapable of responding fairly to individual circumstances.

The Discussion Paper notes that this reduction and/or circumscribing of discretions has been a consistent theme across federal governments. As far back as 1991 it was said that:⁶⁸

Where possible, Commissioner discretions used when ascertaining assessable income will be removed from the Act. In most cases the discretion will be replaced with specific criteria or objective tests to which the taxpayer can refer in determining the relevant amount, apportionment, etc. If a discretion cannot be removed, the Commissioner will make a Taxation Ruling on how he would exercise the discretion, or the taxpayer can seek a Private Ruling on the matter, thereby allowing the taxpayer to self assess on that basis.

The Discussion Paper also notes that, even if discretions are not reduced in number, “it might be possible to reduce the volume of tax law considerably by presenting them in a different way.”⁶⁹

The Discussion Paper classifies the 825 discretions it identifies as:⁷⁰

- 114 liability discretions (24 relating to superannuation);
- 499 discretions relating to administrative matters (administrative discretions) (30 relating to superannuation); and

⁶⁴ *Review of Discretions Discussion Paper*, above n 58.

⁶⁵ See Appendix one for a diagrammatical representation of the policy approach.

⁶⁶ *Review of Discretions Discussion Paper*, above n 58 at 1-2.

⁶⁷ *1991 Self Assessment information paper*, above n 16 at 10.

⁶⁸ *Ibid* at 58.

⁶⁹ *Review of Discretions Discussion Paper*, above n 58 at 4.

⁷⁰ *Ibid*. The liability discretions are listed in Appendix A. The administrative discretions (grouped into sub-categories) appear in Appendix B. The superannuation-related discretions are listed in Appendix C. A complete list of all the discretions in the income tax laws (classified by type), including anti-avoidance discretions, appears at Appendix D.

- 212 discretions to prevent tax avoidance (anti-avoidance discretions) (11 relating to superannuation).

As will be discussed later the typologies of these discretions do not provide for clear boundaries. For example, although s 99A of the ITAA36 is in nature an anti avoidance provision, the discretion in s 99A(2) could be classified as a liability discretion. Although Appendix A of the Discussion Paper seems to contain most of the key liability discretions, there are omissions from the administrative discretions such as s 319(2) of the ITAA36.

This classification conundrum is to be expected and raises some concerns as to just how principled the review approach can be in practice. The discretion targeted for eradication is the so called liability discretion. It is asserted that, from the 1991 Paper, liability discretions have been avoided wherever possible. The Tax Law Improvement Project (which rewrote many of the tax laws and ultimately resulted in the *Income Tax Assessment Act 1997* (ITAA97)) is credited with reducing these discretions. However, a number of liability discretions still exist in the ITAA36.

The Discussion Paper takes the expression 'liability discretions' to mean those that authorise the Commissioner to make decisions affecting assessable income, taxable income and/or tax payable on taxable income.⁷¹ It is considered that these are to be contrasted with the 'good' administrative discretions, such as the Commissioner's power to vary the time or specify the form in which information should be presented. These 'administrative discretions' are generally touted in the Discussion Paper as necessary for the effective operation of the tax system, allowing the Commissioner to focus on practical compliance rather than the letter of the law.⁷² Similarly, some discretions are considered necessary to prevent tax avoidance. Why this classification of liability discretion versus the rest is put in terms of constrain versus accept seems spurious. It is obvious that tax avoidance discretions will determine the quantum of tax a taxpayer is liable to pay. Less directly administrative discretions will do the same, for example the waiving of a lodgment deadline may mean a penalty is avoided or a concession accessed.

It is asserted that the potential operation of liability discretions is a serious flaw in our self assessment system. Tax liabilities may remain uncertain for years after lodgment of a tax return because of the pending (or possible) exercise of a discretion by a Commissioner that affects liability. Taxpayers need to be able to exercise objective reasonableness to determine their liability and not be penalised if that is subsequently disputed. The passage of time between lodgment of a return and the final exercise by the Commissioner is not limited by a test of reasonableness. Also, by the time a discretion is exercised, it may not be possible for the Commissioner to reasonably take into account circumstances that might have existed at the time of lodgment of the tax return. It is not fair for a discretion to be exercised with hindsight. Therefore, any proposal to introduce a greater test of reasonableness, and objectivity is supported.

There can be no basic objection to replacing liability discretions with objective tests. But there is the risk, particularly where there is rewriting of long standing discretion provisions, that an objective test will not be consistent with its original policy. This could result in a narrowing of the practical scope of the discretion without a review of the validity of the original policy position. This can occur where the Commissioner applies a discretion in circumstances not expressly contemplated at the time the

⁷¹ Ibid at 10.

⁷² Ibid at 8.

discretion was enacted. This variation may have occurred due to the courts having adopted an alternative interpretation. For example, the scope of discretion in the domicile test in s 6(1) of the ITAA36 definition of a “resident” or “resident of Australia” has been widened due to the Federal Court’s interpretation of “permanent place of abode” in *Applegate v Federal Commissioner of Taxation*.⁷³ As a result the domicile test also fails to meet its legislative intention of capturing government workers (i.e., the purpose of the domicile test was to extend the scope of the Act to ensure that “. . . Agent-Generals for the Australian States together with members of their staffs, to be treated as residents”⁷⁴).

In a self assessment environment there is also value in seeking to standardise administrative discretions.⁷⁵ Although there may be good small “p” policy for a number of variations to what are similar compliance requirements, such variations create confusion and add to compliance costs. For example the system could be simplified either by using only one form for all elections or an election is deemed to be made on the basis of disclosures in the tax return. Instead of having a specific process for making that election, notification or choice there are confusing multiple alternatives for notifying the Commissioner of an election, transaction or event. It is arguable that this confusion has origins in the adoption of self assessment, which resulted in elections that were lodged with returns being retained. Subsequently, under new tax policy developments decisions were made to require the receipt of information on lodgment. In fact many elections, notices etc:

- are not required in writing (e.g. the choices under the Capital Gains Tax rules do not have to be lodged with the Commissioner);
- have to be lodged and kept by the taxpayer;
- have to be in a prescribed form and others do not; and
- have to be in writing separately from an income tax return and others can be lodged with, or triggered by, the lodging of a tax return.

Any combination of these requirements can apply to an election, notification or choice. For example, the range of elections that have to be in writing and lodged include:

- elections by primary producers under s 392-25 of the ITAA97 that averaging not apply;
- elections by companies under s 319(2) of the ITAA36 of a new statutory accounting period under the Controlled Foreign Company rules; and
- requests by a trustee under s 99A(2) of the ITAA36 for the Commissioner not to apply s 99A of the ITAA36 to income of a trust, to which no beneficiary is entitled.

Similarly, examples where elections must be in writing but not lodged include:

- a notice of a nominated replacement car under s 28-130 of the ITAA97 for the purposes of the substantiation rules;
- elections under s 139B(2) of the ITAA36 for the discount on shares to be assessed in year of acquisition; and

⁷³ *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899; 79 ATC 4307.

⁷⁴ *Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth)*, 10.

⁷⁵ The following discussion in this section has been in part sourced from Michael Dirkis “Exposing the forgotten stepchild: The poor execution in compliance and administration” (paper presented at the Australian Tax Research Foundation’s Executing Australia’s Income Tax conference, Sydney, 20 October 2006).

- elections to rollover part of an eligible termination payment (ETP) under s 27D of the ITAA36.

A second area of concern in respect of administrative discretions is the use throughout the tax laws of the requirement that, in providing information to the Commissioner, it must be "in the approved form". Drafters have often included as a matter of practice the requirement to supply information "in the approved form". The problem is that in many cases there is no prescribed form. This causes confusion and additional compliance costs as taxpayers search for non-existent forms. One example is s 284-225(1) of the *Taxation Administration Act 1953* (the TAA), which provides for the reduction of the base penalty amount by 20 percent if certain criteria are satisfied. In order to take advantage of s 284-225(1), s 284-225(2) requires the taxpayer to voluntarily tell the Commissioner "in the approved form" about any shortfall, but there is no such form. Subsection 388-50(1) of the TAA stipulates that a statement or other document under a taxation law is in an approved form if, and only, if it is in the form approved in writing by the Commissioner for that kind of statement or other document.

In a self assessment world it can be argued that the Commissioner should have an additional power to waive certain requirements and formalities in the tax law in order to reduce compliance costs for taxpayers. This may overcome the difficulties that arise from over prescriptive law (e.g. the recent problem areas of substantiation, Family Trust Elections and ITAA36 Division 7A). A possible starting point would be the criteria setting out the circumstances where a Commissioner will apply the general administrative power i.e.:

- be consistent with the policy intent of the legislation;
- achieve substantive compliance at reduced cost;
- as far as practical reflect industry practice;
- ensure that any resulting risks to the revenue are appropriately managed;
- avoid material adverse impacts on third parties; and
- retain taxpayer choice as to whether to adopt the approach or not.⁷⁶

However, as this process operates only where the solution is consistent with the policy intent of the legislation, it will offer little relief where the legislation does not allow the Commissioner any flexibility. This limitation could be removed and replaced with a form of public benefit based test. Such a test would respond to this identified inflexibility. Though defining what is the 'public benefit' in a given situation would be subject to its own vagaries. This would be tempered by the Commissioner being accountable to articulate why the use of the general administrative power was in the public interest and over time the operation of a discretion so worded would become more certain.

Finally, certainty through brevity or excision is not the only focus when dealing with liability discretions. The Discussion Paper notes that there are approximately 70 public rulings and 45 Law Administrative Practice Statements that discuss liability

⁷⁶ Michael Carmody (Commissioner of Taxation) 'The art of tax administration -Two years on' (Paper presented on 15 April 2004 to the 6th International Conference on Tax Administration: Challenges of Globalising Tax Systems, Sydney), 4. At URL: <http://www.ato.gov.au/corporate/content.asp?doc=/content/00123108.htm> accessed 16 December 2007.

discretions.⁷⁷ As well taxpayers can request private rulings. In this way the paper notes that taxpayers can get certainty in their tax affairs. Though there is no reason that the same argument can not be advanced for administrative and anti-avoidance discretions.⁷⁸

Again it needs to be borne in mind that certainty of outcome does not necessarily equate to fairness of outcome. In a self assessment environment the need for certainty is obvious. Without it the taxpayer is at risk with respect to decisions they must make in determining their tax liability should the Commissioner unexpectedly exercise the relevant discretion in a manner adverse to the taxpayer. However, a rigid, yet certain, pro-revenue, set of 'objective' tests replacing discretions may not be a fair replacement for the taxpayer.

C Review of Unlimited Amendment Periods in the Income Tax Laws

The ability to amend assessments is central to the operation of self assessment in the Australian tax system. By exploring some of the themes running through the *Review of Unlimited Amendment Periods in the Income Tax Laws – Discussion Paper* (the Discussion Paper)⁷⁹ it is proposed to provide insight into the power balance between the taxpayer and the ATO. More importantly it can demonstrate where the Treasury sees that balance being struck into the future.

In summary the Discussion Paper seeks to advance ROSA recommendation 3.7 by examining unlimited amendment periods and proposing to replace most of them with either standard amendment periods, fixed amendment periods, or amendment periods based on a contingent event. The provisions considered in the paper include the superannuation and income dependent levies such as the Medicare levy. The GST and other indirect taxes are not within its scope, but should be examined as part of the Board of Taxation's inquiry into applying consistent self assessment principles across all federally administered taxes. Despite the changes in 2005 to limit amendment periods, there are still over 100 situations where the period in which an amendment to an assessment can be made remains indefinite.⁸⁰

The following extracts from the Discussion Paper are instructive of the viewpoint from which the review is being advanced. Firstly, the Discussion Paper clearly acknowledges the interests of the taxpayer in having certainty in their tax affairs and the tension between this and system integrity. It points out that:

Unlimited amendment periods represent an extreme case of uncertainty, as the time to amend extends indefinitely. If that time can be limited without prejudicing the integrity and function of the system overall, the 'costs' of risk and uncertainty would be reduced.⁸¹

⁷⁷ *Review of Discretions Discussion Paper*, above n 58 at 2 and at footnote 3 it gives the example: *Taxation Ruling TR 97/24 Income tax: relief from the effects of failing to substantiate* that explains how the Tax Office exercises the discretion (in s 900-195 of the ITAA97) to grant relief where a taxpayer fails to substantiate expenses.

⁷⁸ *Ibid* at 10 notes that a project to examine certain aspects of the use of anti-avoidance provisions, including the possible redundancy of some provisions, is being considered separately by Treasury.

⁷⁹ *Review of Unlimited Amendment Periods Discussion Paper*, above n 59.

⁸⁰ *Ibid*, Appendix A. These provisions are located within the ITAA1936, the ITAA1997, the *Superannuation Industry (Supervision) Act 1993* and the *International Tax Agreements Act 1953*.

⁸¹ *Ibid*, at 7.

The Discussion Paper also acknowledges the need for symmetry between the taxpayer and tax administrator.

Unlimited amendment periods are not used exclusively to enable the Commissioner to increase taxpayer liability. Most provisions are symmetrical in that they also enable taxpayers to review their assessments to reduce their tax liability. Both cases should be treated equally when determining whether an unlimited amendment period remains appropriate for that provision.⁸²

But this call to formal equality does not address or discuss the power imbalance between the ATO and a taxpayer in respect of resources and knowledge. In fact the footnote extracted above is about the only direct statement acknowledging that taxpayers may wish to revise their assessments where they have paid too much tax. The Discussion Paper then focuses through system integrity as the prism to discuss the merits of amendment periods. Only lip service is paid to power balances and the interests of the taxpayer outside of their need for certainty. That certainty is seemingly easy to subvert in the interests of revenue collection. For example just having complex tax affairs is a reason for substantial amendment periods:

... in some instances a longer than standard amendment period is warranted to ensure that the Commissioner can apply the tax laws equitably and ensure compliance, particularly for more complex transactions. ... Verifying the details of transactions for taxpayers with complex tax affairs involving substantial amounts of money requires more comprehensive examination and thus takes longer. Delays in the verification process may be due to limited access to facts or evidence, claims of legal professional privilege that need to be resolved, administrative law remedies, delays in obtaining information or time to comment on the Commissioner's statements of facts or position papers.⁸³

If it takes so long to check matters maybe it would be better to reassess the substantive law so the events giving rise to the tax liability are more concrete or, just allocate more resources to that verification task if it is such a priority. But as can be inferred from the quote above the preferred model seems to be that the risk is left with the taxpayer over a long amendment period.

Less controversial is the position where evasion or avoidance is alleged. Even here there is the blurred and subjective boundary between tax planning and avoidance.

[V]ery long or unlimited amendment periods can be justified where taxpayers deliberately seek to evade their responsibilities or to defraud the revenue. A number of countries, including Canada, New Zealand and the United States, have legislation placing taxpayers permanently at risk if they have deliberately sought to evade their tax liabilities.⁸⁴

The Discussion Paper concludes that:

... while short amendment periods provide greater certainty for taxpayers, setting periods too short may jeopardise the capacity of the Commissioner to detect non-compliance. A balance needs to be reached between the two competing objectives.⁸⁵

That balance in the Discussion Paper seems too easily struck in favour of the revenue, leaving the taxpayer at risk for the length of the amendment periods. This

⁸² Ibid.

⁸³ Ibid.

⁸⁴ The 2004 *ROSA Discussion Paper*, above n 2 at 32 Table 3.1; notes that all comparable countries have an unlimited amendment period for fraud and evasion, except for the United Kingdom where the period is 20 years and 10 months.

⁸⁵ *Review of Unlimited Amendment Periods Discussion Paper*, above n 59 at 7.

debate will always be a feature of a self assessment model. A fair reading of the paper will recognise a stated concern for the taxpayer's position and their need for certainty. Yet, the examples used are all where that runs second (at best) to system integrity and compliance. From the extracts above it seems that being wealthy and having complex tax affairs is reason enough for certainty to be in second place to the revenue. Further, the power imbalance between the taxpayer and the ATO once mentioned barely rates serious exploration in the paper.

These issues are further considered in the context of the Discussion Paper's seven reform principles.

Principle 1: Unlimited Amendment Periods for circumstances that can be dealt with within the general rules should be removed

Unobjectionably, if there is sufficient time for the Commissioner to examine the claim and make any necessary amendments to the relevant assessment and there is no continuing compelling reason for having a special amendment period, the unlimited amendment period will be repealed.⁸⁶ As we will see under the following principles the Discussion Paper finds space for extended, if not unlimited, amendment periods to protect system integrity at the cost of taxpayer certainty.

Principle 2: Unlimited Amendment Periods for circumstances that will take more than four years to verify because of unusual complexity or other factors should have a longer fixed amendment period.

Transfer pricing is the key area the Discussion Paper identifies where Principle 2 could apply.⁸⁷ The Discussion Paper argues that general rules which allow for a two-year or four-year amendment period may not be sufficient to examine cases such as transfer pricing, due to the complexity of those transactions and the difficulty in obtaining verification information.⁸⁸ Nevertheless it argues that, even for these cases, a finite amendment period may be more appropriate than an unlimited amendment period. It suggests that the timeframe for a longer amendment period should be sufficient for the Commissioner to ensure compliance, but not so long as to create unwarranted risk and uncertainty for taxpayers involved. It suggests a compromise of eight years, from the time the Commissioner gives the taxpayer the notice of assessment as being the more appropriate amendment period.

However, in the context of transfer pricing this argument is flawed. Given the information requirement imposed under the Schedule 25A Disclosure Statement and the significant transfer pricing documentation requirements (costing between \$50,000 and \$100,000 for simple cases), this argument is difficult to sustain as the information is available to the ATO. Rather, we see the revenue being protected at the cost of certainty in a self assessment environment. By and large it is the taxpayer that is bearing the cost.

Principle 3: Unlimited Amendment Periods for circumstances that arise because of a future event should be based upon a set time after the Commissioner is notified that the event has occurred.

This is the most contentious of all the principles as it seems to reverse self assessment by imposing further notification obligations on taxpayers. Further, as the

⁸⁶ Ibid. The Discussion Paper identifies 36 situations that require repeal.

⁸⁷ Ibid at 11.

⁸⁸ Ibid.

Discussion Paper recommends the application of this principle in over 70% of identified cases of unlimited amendment periods listed in Appendix A to the Discussion Paper (80 provisions out of a total of 119), so there is still considerable scope for taxpayers to be subject to unlimited amendment periods.⁸⁹

The Discussion Paper provides a number of examples of provisions that currently have unlimited amendment periods to enable the amendment of assessments to be based on an event that may occur at an unknown time in the future, usually outside the general amendment periods of two or four years. Examples cited include ss 51AH (which denies deductions where expenses incurred by an employee are reimbursed) and 82KL (which denies deductions in respect of certain recouped expenditure) of the ITAA36. The Discussion Paper argues that the standard amendment period would often render the Commissioner unable to amend assessments to prevent taxpayers retaining deductions where they have ultimately not incurred the expense themselves.⁹⁰

However, an unlimited amendment period that leaves taxpayers at risk indefinitely is unnecessary. Any amendment should occur within a reasonable time after the relevant contingent event occurs. In the above case the contingent event would be when the Commissioner is notified of the recoupment of the expense. If no notification occurs, the timeframe for amendment would remain open.

Despite all this, as acknowledged in the Discussion Paper, the bottom line is that this principle will not achieve finality for all taxpayers.⁹¹ The taxpayer carries the onus of notifying the Commissioner that the prescribed contingent event has occurred. Without this notification, the benefit of a limited review period will not be triggered and the amendment period for matters related to the contingent event will remain indefinite. From the perspective of this paper it is not an answer to this point to assume that taxpayers in this position would generally have the services of tax adviser. The onus has been placed on the taxpayer rather than the ATO and that is the focus of this paper, not the compliance costs imposed by this onus.

Principle 4: Unlimited Amendment Periods (other than for fraud or evasion) should only be retained in exceptional circumstances.

The Discussion Paper argues fairly and logically that unlimited amendment periods will remain in cases where:

- the basis for the amendment power is that the Commissioner is of the opinion there has been fraud or evasion;
- where there is a need to give effect to a decision on a review or appeal, or as a result of an objection made by a taxpayer; or
- where absolutely necessary to give reasonable effect to the provision.⁹²

Principle 5: Amendments to prior year assessments to give effect to changes in the law brought about by amending Acts should be made within 2 years of Royal Assent of the amending Act.

This recommendation applies to 80 Acts amending tax legislation passed between 1991 and 2005 where unlimited amendment periods are included as a standard

⁸⁹ Ibid.

⁹⁰ Ibid at 13.

⁹¹ Ibid at 12.

⁹² Ibid at 14-15.

feature.⁹³ This clause was often inserted due to uncertainty surrounding the timing of the passage of an amending Act. The clause effectively disables the time limits imposed by the tax legislation to allow the Commissioner to amend assessments in line with the new law regardless of whether the legislation is delayed in Parliament or whether the legislation was to apply retrospectively. It places no time restriction on the Commissioner's power to give effect to the amended law.

To close off existing unlimited amendment period provisions of this type, the Discussion Paper suggests amendments could be made so that these periods of review expire two years after a nominated date (e.g. the date of Royal Assent of the Act amending other unlimited amendment periods as the outcome of this Review). The Commissioner would therefore retain the capacity to amend assessments as a result of these Acts, but would be limited to doing so within a specified time.

This does not require further discussion as it is an appropriate response to over zealous drafting which was aimed at revenue protection and made in the context of an avalanche of legislative change.

Principle 6: A finite period of review should apply even though taxpayers who have lodged a return do not receive a notice of assessment.

This issue is probably not strictly speaking one where the legislation imposes an unlimited period of review. Rather it is illustrative of a processing failure arising from the impact of the ROSA.⁹⁴ The effect of the *Tax Laws Amendment (Improvements to Self Assessment) Act (No 2) 2005*, which arises from ROSA, is to:

- amend the definition of assessment in s 6(1) of the ITAA 1936 to include the fact that an assessment exists where there is an ascertainment that there is no tax payable; and
- amend s 170(1) of the ITAA36, Item 4, such that the period for amendment of a trust is limited to four years from the day the Commissioner gives the taxpayer notice of the assessment.

However, in December 2005, prior to the royal assent and in the middle of an income year, the ATO stopped issuing non-tax notices to trustees of trusts. This effectively means that where a trust has no taxable income its period for review is unlimited.⁹⁵ There appears to be both legislative and administrative concerns underlying the decision.

On the legislative side the ATO argues that:

Whilst it may be possible to issue nil assessments from information included in a trust return, this would not cover all potential trustee assessments which could arise from a trust return, for example section 98 default beneficiary assessments - such default beneficiaries would not have been included in the distribution statement for nil assessment purposes (because they would not be considered to have a present entitlement). Any assessment subsequently issued to them (or rather to the trustee) would be a nil assessment for which the Commissioner would have unlimited time to issue.⁹⁶

⁹³ Ibid; a list of the 80 Acts with the generic unlimited amendment period is in Table B.

⁹⁴ ROSA Discussion Paper above n 2.

⁹⁵ At the NTLG meeting of 5 September 2006 the ATO confirmed that "Under existing practices, a notice of assessment is not issued to a trustee unless there is a positive amount of tax to which the trustee is to be assessed. This means that for the various types of trustee assessment provided for in Division 6 of the ITAA36, where no tax is payable for the year of income, no period of review would commence under current legislative arrangements" - see NTLG Draft Minutes for the meeting of 5 September 2006 - Item 14.

⁹⁶ See NTLG Agenda for the meeting of 7 December 2006 - Item 23.

Similarly, where there is nil income, it is difficult to satisfy the present entitlement under the various assessing rules.

On the administrative side the ATO advised:

Issuing notices for the full range of non-taxable circumstances for each trustee would create significant administrative difficulties for the Commissioner, as there are over 450,000 non-taxable trusts. Compliance costs would also be increased as the Tax Office does not currently collect the required information to identify the range of nil assessments for which the trustee may potentially be liable. A redesign of the trust return form would be required to capture this information to facilitate the generation of the required assessment notices.⁹⁷

In the context of the current major rebuild of the ATO's processing systems (the so-called "Change Program") it is understandable that the ATO is reluctant to commit the resources to redesign systems that will become redundant in 12 months.

The ATO also argues that to proceed down this line would also create additional reverse work flows for tax agents as the ATO currently accepts and processes these tax returns where tax agents have not completed the beneficiary details in the 'Statement of distribution' section of the Trust tax return. The ATO warns that should it "... be required to issue notices of assessment to trustees, those returns that do not disclose the beneficiary details and the relevant assessment calculation code would be considered incomplete."⁹⁸

Thus, the ATO proposes to adopt an interim administrative solution which:

... would involve a binding undertaking by the Commissioner not to issue an original assessment (of a positive amount) to the trustee beyond the usual review period, except where there has been fraud or evasion. This would give comfort to trustees wanting certainty for a particular income year. It would ensure fairness and equity of treatment for trustees with nil liability or loss returns.⁹⁹

Also, the ATO has adopted an administrative practice not to issue an original assessment (of a positive amount) to the trustee beyond the usual review period, except where there has been fraud or evasion. The ATO has foreshadowed that an amendment to the law might be required to clarify this area. This illustrates poor tax policy implementation. The ATO neither considered the difficulties of implementing these ROSA changes, nor did it upgrade its information requirements in light of a perceived risk. As a result the potential compliance costs and risks are increased for taxpayers.

The proposed solution in the Discussion Paper is to only allow the Commissioner to raise an assessment within four years from the later of the due date for lodgement of the return or the actual lodgement of the return would effectively provide an amendment period for trustees who had not received an assessment.¹⁰⁰ Whether this legislative change is necessary remains an open question.

Principle 7: Transitional arrangements should close off amendments to assessments from previous years, after allowing the Tax Office sufficient time to review past assessments.

This is a procedural matter and the Discussion Paper sets out the scope of possible transitional arrangements.¹⁰¹ It argues that the transitional arrangements should close

97 See NTLG Draft Minutes for the meeting of 5 September 2006 – Item 14.

98 Above, n 96.

99 Above, n 97.

¹⁰⁰ *Review of Unlimited Amendment Periods Discussion Paper*, above n 59 at 17.

¹⁰¹ *Ibid* at 18.

off assessments from previous years, after giving the ATO time to complete reviews of past assessments. Transitional arrangements need to ensure the Commissioner has no less time than the proposed new amendment periods to finalise prior year returns.

IV HAS THE IMBALANCE BEEN ADDRESSED?

It is essential that for any tax system to operate effectively it should be *perceived* as equitable, both in the way tax is levied and in the administration of the system. Therefore the focus on any reform should be on the objectives of self assessment and how the costs and burdens of achieving these objectives ought to be shared more equitably. It will be remembered that the Asprey Committee, in considering the essential aims of efficiency, fairness and simplicity in a tax system, said:

Thus, the Committee is to consider the effects of the system upon the 'economic and efficient use of the resources of Australia', the desirability that there should be a 'fair distribution of the burden of taxation', and that revenue-raising be 'by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.'¹⁰²

In the Taxation Institute's 28 May 2004 submission on the original ROSA proposals it was stressed that, although it supported a reduction in the ATO's periods of time to amend, it did not support the rationale behind matching review periods for the ATO and taxpayers. Underlying the Taxation Institute's position is that the Treasury rationale for symmetry is flawed as it proceeds on the basis that the Commissioner and taxpayers are on an equal footing. As the Commissioner still retains a dominant position longer periods of review are needed to give taxpayers the time to vary returns where they have made a mistake or where there is an ATO error.¹⁰³ Here the role of tax advisers in the tax system is of course important. However, in the context of an exploration of the principles underlying the self assessment system their role is outside the direct scope of this paper which is an analysis of the bilateral relationship of taxpayer and ATO.

Given ATO dominance in the relationship, there is little reason to continue the matching principle in respect of the taxpayer's review period. Consequently, the periods for review no longer need to match and the time period for credit assessment should be unlimited. Alternatively, an overarching provision should be introduced to extend amendment periods in such circumstances.

V CONCLUSION

It must not be forgotten in any review in this area that self assessment was the direct result of a desire to reduce the overheads of the tax administrator. What was lost in that 1986 decision making process was the adverse and inequitable impacts of placing the responsibility for determining taxpayers' tax liability on those taxpayers without giving them the tools to do so. These impacts are further compounded by the fact that over the same period the law has become more voluminous and complex (the Income Tax Acts alone growing from about 4,000 pages in 1998 to over 9,000 in 2007).

¹⁰² Preliminary Report of the Taxation Review Committee (Asprey Committee) June 1974 at para 3.6. See also *A Tax System Redesigned* above, n 32 at 15-17.

¹⁰³ Deductions for self-education expenses were handled incorrectly in *TaxPack* for a number of years. When the error was discovered, many taxpayers were unable to access refunds because the 4 year period for amendment had elapsed. Thus, an ATO error resulted in a significant windfall gain for the ATO.

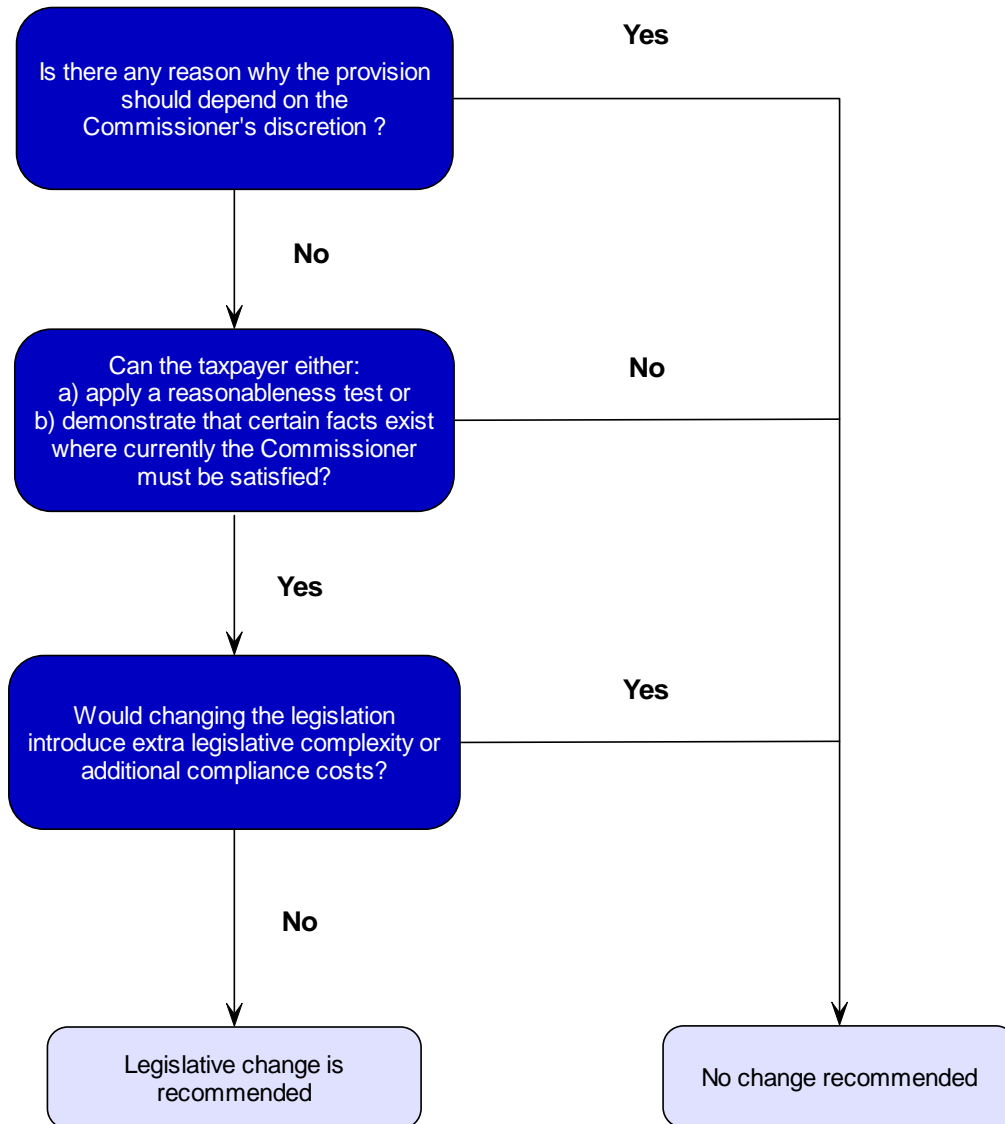
The legislative changes in 1992 and 2005 and the implementation of (or progress towards) the majority of the administrative recommendations of ROSA do suggest some major steps have been taken in redressing those fundamental policy failures. Yet the Treasury discussion papers still reveal a fundamental failure to recognise the continuing power imbalance between the majority of taxpayers and the ATO. The papers focus on compliance not equity. Therefore, it is not surprising that the Inspector General of Taxation has been compelled to review progress made in respect of binding advice.

In conclusion, despite self assessment reaching the historic age of majority, it is premature to declare that the self assessment reform is complete. There has been more of an asthma attack than one last gasp in the process of balanced reform.

Appendix 1:

The Policy approach set out in Treasury, *Review of Discretions in the Income Tax Laws - Discussion Paper* (June 2007), at 14.

Figure 1: Process for review of liability discretions



TAX ACCOUNTING CONCESSIONS FOR SMALL BUSINESS ENTITIES: ONE SMALL STEP FOR SMALL BUSINESS

PAUL KENNY*

I INTRODUCTION

This paper examines the Small Business Entities (SBE) income tax accounting concessions (for prepaid expenses;¹ depreciating assets² and trading stock³) that commenced on 1 July 2007. These concessions originated from the former Simplified Tax System (STS).⁴ Given that the former STS was subject to much criticism by commentators, professional and government bodies⁵ this paper first tracks the origins of the STS in the 1999 *Review of Business Taxation's* (herein after called the 'Review') report,⁶ its implementation and the subsequent legislative fixes up to 30 June 2007. The paper then examines the SBE regime and finds that the new SBE framework retains many of the features of the former STS and thus is open to similar criticisms. The SBE regime though provides a more flexible framework for small

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1 s 82KZM Income Tax Assessment Act 1936 (ITAA 1936).

2 Subdiv 328-D Income Tax Assessment Act 1997 (ITAA 1997).

3 Subdiv 328-E.

4 s 82KZM ITAA 1936, Div 328 ITAA 1997.

5 Pizzacalla M, 'Australia's SME identity crisis' (2007) 22 Australian Tax Forum 19; Samarkovski Freudenberg above n 7; Tretola J (2007) 'The Simplified Tax System - Has It Simplified Tax At All And, If So, Should It Be Extended?' (2007) 17 Revenue Law Journal; McKerchar M, 'Is the Simplified Tax System Simple?' (2007) 10 The Tax Specialist 140; Burton M, 'The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?' (2006) 21 Australian Tax Forum 71; CPA Australia, Small Business Survey: Compliance Burden (2006); Taxation Institute: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005 <www.regulationtaskforce.gov.au/submissions/sub078.rtf>; Institute of Chartered Accountants: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005; G Shaw, 'Changing to the Simplified Tax System' (2005) Taxpayers Australia 7 November 2005, 154; Dirkis M and Bondfield B, 'The RBT ANTS Bite: Small Business the First Casualty' (2004) 19 Australian Tax Forum 107; Walker G, 'The Simplified Tax System- the Good, the Bad and the Ugly' (2003) 7, 20 CCH Tax Week 95; Bondfield B, 'A Year on in the Simplified Tax System: has the reality matched the rhetoric?' (2002) 37 Taxation in Australia 253; Kenny P, 'A Simplified Tax System for Small Business: Or, Just Another Tax Preference?' (2002) 6 The Tax Specialist 36; Bondfield B, 'If there is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 Australian Tax Forum 313; Hine M, 'Small Business Tax System (STS)' Taxation Institute of Australia, Western Australian State Convention May 2001, 24; Snook I, 'Simplified Tax System: A Favourable Current, a Riptide or Just Plain Dead Calm?' Taxation Institute of Australia, South Australian State Convention May 2001, 75; Wolfers L and Miller J, 'The Simplified Tax System: Is this Government Speak for "Complex"?' (2001) 35 Taxation in Australia 374; Martin F, 'STS Implications' (2001) 36 Taxation in Australia 245; Douglas R, 'Tax Simplification for Small to Medium Business' (2000) Taxation Institute of Australia New South Wales State Convention May 2000, 8; Institute of Chartered Accountants (ICAA) Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000; Cooper G, 'The Government Response to the Ralph Report: An Initial Overview' (1999) 34 *Taxation in Australia* 232.

⁶ Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable, Report* (1999) (herein after called a *Tax System Redesigned*). The Report was the last in a series of four papers published by the Review of Business Taxation.

business and it is somewhat better integrated with other small business taxation concessions.

II BACKGROUND: THE FORMER STS

A The Review of Business Taxation's STS

The *Review's* first paper, *A Strong Foundation*⁷ and its report, *A Tax System Redesigned*⁸ both identified the general problem of onerous compliance costs for small business. For example, in 1996, the *Small Business Deregulation Taskforce* (herein after the *SBD Taskforce*)⁹ observed that tax loomed as the main regulatory compliance issue for small business.¹⁰ Notwithstanding the efforts of the *SBD Taskforce*, with the extensive tax reforms flowing from the *Review's* 1999 report¹¹ and the introduction of the goods and services tax on 1 July 2000,¹² the taxation laws expanded from some 3,000 odd pages of legislation in 1996 to over 10,000 pages in 2007. Moreover the costs of tax compliance for small business are highly regressive.¹³ As the *Review* noted, the limited resources of small businesses mean that such businesses work under the constraints of sub optimal systems and limited knowledge to comply with a mass of taxation regulations and record keeping requirements.¹⁴ Leading tax practitioner bodies have similarly argued that tax laws impose a significant burden on small business.¹⁵

However, the *Review*¹⁶ inappropriately attributed this problem to the perceived difficulties that small businesses were having with the following four income tax accounting issues: the accruals income tax accounting rules,¹⁷ the prepayment framework,¹⁸ the capital allowances regime¹⁹ and the trading stock rules.²⁰ Thus the

⁷ Review of Business Taxation, *A Strong Foundation Discussion Paper* (1998) (herein after called *A Strong Foundation*), 14-22.

⁸ *A Tax System Redesigned* above n 6, 575.

⁹ C Bell (Chair) *Time for Business: Report of the Small Business Deregulation Task Force*, AGPS, Canberra, 1 November 1996; Taxation Institute of Australia, 'Current Topic, Small Change' (1996) 31 TIA 174, 174-175.

¹⁰ Small Business Deregulation Task Force Background Paper 3, September 1996; House of Representatives Standing Committee on Industry, Science and Technology, D Beddall MP (Chair) *Small Business in Australia- Challenges, Problems and Opportunities; Recommendations and Main Conclusions*, AGPS, Canberra, January 1990.

¹¹ *A Tax System Redesigned* above n 6. For example small businesses were affected by the NCL provisions in Div 35 ITAA 1997 and the alienation of personal services provisions in Pt 2-42 (Divs 84-87).

¹² *A New Tax System (Goods and Services Tax) Act* 1999.

¹³ C Evans, K Ritchie, B Tran-Nam, M Walpole, *A report into taxpayer costs of compliance* (1997), 85. Smaller businesses have fewer resources to comply with tax legislation and thus their tax compliance costs expressed as a percentage of business revenue are far higher than larger businesses.

¹⁴ *A Tax System Redesigned* above n 6, 74.

¹⁵ S Harrison, (CEO) Institute of Chartered Accountants in Australia, Open Letter to Tax Commissioner Carmody, 13 August 2002, <http://www.icaa.com.au/news/index.cf?menu=226&id=A105289876>; R Regan, (President: National Tax & Accountants Association) NTAA supports call for tax practitioners to revolt, National Tax & Accountants Association Press Release 15 August 2002; G Levy Tax Crisis – Hard Times Call for Hard Actions, Taxation Institute of Australia Press Release, 13 August 2002, <http://www.taxinstitute.com.au/cda/media/1,1316,1,00.html>.

¹⁶ *A Tax System Redesigned* above n 6, 575.

¹⁷ ss 6-5, 8-1 ITAA 1997.

¹⁸ s 82KZM ITAA 1936

¹⁹ Div 40 ITAA 1997

Review introduced ‘simplified’ rules for small business for: a cash system of income tax accounting,²¹ treatment of prepaid expenses,²² capital allowances²³ and trading stock.²⁴ The cash accounting system proved to be unhelpful and was repealed on 30 June 2005.²⁵ It is evident from the following analysis that the non-STS income tax accounting rules for prepayments, capital allowances and trading stock did not greatly burden small business.

Taxpayers outside of the former STS that carried on a business could only generally claim a deduction for prepayments over the period to which the prepaid benefits related (eligible services period).²⁶ Such prepayments were apportioned over the lesser of 10 years or the eligible services period.²⁷ Such treatment broadly reflects proper financial accounting practice as such prepaid expenses should be accrued over the period that directly relates to the earning of income.²⁸ Thus, the impact of these prepayment rules on compliance and administration costs for small business is manageable.

Taxpayers outside of the STS could access the general capital allowance rules in Div 40 ITAA 1997. There are a few reasons why the compliance costs of Div 40 would not be overly onerous to small business taxpayers, tax practitioners and administrators. First, these depreciation provisions based on effective life broadly reflect proper financial accounting practice.²⁹ Secondly, Div 40 has operated since 1 July 2001 and thus this regime is now well established. Thirdly, given the widespread use of computers to calculate depreciation these costs appear to be manageable for small businesses. Fourthly, given the small scale of their operations many small businesses are likely to have relatively few depreciating assets and thus any compliance costs under Div 40 would be small.

For non-STS taxpayers the trading stock rules in Div 70 are well established³⁰ and are broadly similar to the accounting trading stock rules.³¹ Consequently, Div 70 is well understood by small businesses, tax practitioners and administrators. Overall, the trading stock compliance costs do not appear to be onerous for small business since these calculations are required for financial accounting³² as well as internal control³³ purposes.

Overall, for small business taxpayers that were not part of the former STS concessions, the prepayment, depreciation and trading stock provisions would not have imposed any serious compliance costs since these measures are required for financial accounting, managerial accounting and internal control purposes. These tax

²⁰ Div 70.

²¹ Former subdiv 328-C.

²² s 82KZM ITAA 1936.

²³ Subdiv 328-D ITAA 1997.

²⁴ Subdiv 328-E.

²⁵ Explanatory Memorandum, *Tax Laws Amendment (2004 Measures No. 7) Act 2005*.

²⁶ s 82KZMD(2) ITAA 1936.

²⁷ *Ibid.*

²⁸ AASB *Framework for the Preparation and the Presentation of Financial Statements*, paras 22, 93.

²⁹ *Ibid* paras 22, 96, In recognising expenses associated with the using up of assets such as plant and equipment the expenses are recognised in the accounting period in which the economic benefits associated with these items are consumed or expire.

³⁰ Div 70 ITAA 1997 commenced on 1 July 1997.

³¹ AASB *Framework* above n 28, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

³² *Ibid.*

³³ J Hoggett et al, *Financial Accounting*, (6th ed, 2006), 255: Stock takes are required to detect accounting errors, losses and theft.

accounting provisions are long established and thus appear to be well understood by small business, taxation practitioners and administrators.

In July 1999 the *Review* recommended that the STS be introduced to reduce the compliance costs faced by small businesses.³⁴ Eligible small businesses could elect to join if their annual turnover or annual receipts were less than \$1 million, exclusive of Goods and Service Tax, and where they derived less than 5 per cent of their income from a leasing activity.³⁵ Under the proposed STS, small business would use cash accounting for business income and day-to-day expenditure (including a special treatment for prepayments) as an alternative to an accruals based regime.³⁶ Also, a simplified depreciation regime utilising pools would apply as an alternative to the general depreciation regime.³⁷ Further, a simplified trading stock regime would apply as an alternative to undertaking stocktakes and stock valuation.³⁸ The *Review's* STS recommendations appear to have been the flagship of its reforms for small business, being one of its largest tax expenditures³⁹ that would help a great number of taxpayers.⁴⁰

B Implementation of the STS

Subsequent to the release of the *Review's* report in September 1999 the federal Government sought consultation on the *Review's* STS proposals by asking for submissions on its *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*. However, consultation on this Bill was strictly limited.⁴¹ Submissions criticising the design and complexity of the STS were provided to the federal Government.⁴² For example, industry bodies pointed to its lack of commerciality and unsuccessfully requested a wider definition of small business (with higher annual turnover thresholds), simpler integrity measures for groups and optional treatment of the four elements of the STS concessions, rather than mandatory application.⁴³ These concerns were ignored.⁴⁴

³⁴ *A Tax System Redesigned* above n 6, 575.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ *A Tax System Redesigned* above n 6, 698, 721.

⁴⁰ *Ibid* 576, The *Review* referred to 1993 data from the Australian Bureau of Statistics that 95 per cent of businesses would be eligible to join the STS since their turnover was less than \$1 million. Given that the STS did not commence until 1 July 2001 this figure appears to be grossly inflated.

⁴¹ Commonwealth Treasury National Tax Liaison Group meeting 7 December 2000, <<http://www.ato.gov.au/content.asp?doc=/content/Professionals/13389.htm&page=3#H6>>, The National Tax Liaison Group meeting minutes noted that 'Treasury viewed the STS consultation as very close to 'ideal', but were concerned that professional bodies did not share this view.'

⁴² Taxation Institute of Australia, Submission on the *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*, 17 November 2000, 8.

⁴³ Bondfield above n 5, 359 notes that these issues were raised in a joint response made by the Taxation Institute of Australia, CPA Australia, Farmer's Federation and Council of Small Business Organisations of Australia.

⁴⁴ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* para 1.6 though asserted: 'Consistent with the Governments approach to business tax reform, the detailed design of the STS has benefited from extensive consultation with business representatives and professional bodies.'

Consequently, the federal Government generally agreed⁴⁵ with the STS recommendations as detailed in the *Review's* report and these rules provided the basis for STS legislation contained in Div 328 ITAA 1997 and s 82KZM ITAA 1936. As discussed below, it was only after the introduction of the STS and some years of experience with its difficulties that the federal Government moved to reinvent the STS.

In implementing the STS, there appears to have been some uncertainty as to the federal Government's policy goals.⁴⁶ In the STS Explanatory Memorandum the federal Government provided a rationale of simplification of record keeping and reporting for the small business sector.⁴⁷ However, the Explanatory Memorandum⁴⁸ and s 328-50(1) ITAA 1997 both provided a secondary rationale for the STS concessions, asserting that these provisions would reduce the effective tax burden for small business by reducing their tax. Thus the STS appeared to have had two policy goals.

The federal Government had in mind STS concessions that would appeal to most small businesses given that '95% of all businesses' would be eligible.⁴⁹ However, this 95 per cent figure was overstated, for example, only 14 per cent of eligible small business adopted the STS in the year ended 30 June 2002.⁵⁰ As a result, it is evident that the primary STS policy goal of simplification for the small business sector was undermined given the unpopularity of the STS concessions. The secondary goal of reducing taxation for small business would be similarly unattainable given the low number of adoptions by small business.

The former STS was introduced on 1 July 2001 and as noted above, it comprised of a package of four elements involving: accounting methods,⁵¹ prepaid expenses,⁵² capital allowances⁵³ and trading stock.⁵⁴

The STS contained a number of structural flaws. The STS eligibility criteria failed to provide an appropriate universal definition of a 'small business'. The *Review* did not point to any research to underpin its definition of small business.⁵⁵ This is a structural flaw since all small businesses and only small businesses needed to be included the STS concessions. To simplify taxation law such a definition of 'small business' is needed to replace all other definitions of small business contained in the

⁴⁵ The major difference replacement with the 'less than 5% leasing income' criterion (See the *Review's* recommendation 17.1 above) with exclusions for leased assets from the STS capital allowances regime. Another requirement was added with the \$3 million depreciating assets limit in the former s 328-365(1)(c). Some minor modifications were made to the capital allowances recommendations. For example, depreciating assets with an effective life of 25 years or were to be dealt with by the general capital allowances provisions in Div 40 (recommendation 17.3(iii)). This was changed to include these assets in an STS long life pool with a 5% depreciation rate.

⁴⁶ McKerchar above n 5, 140-141.

⁴⁷ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* paras 1.5-1.7.

⁴⁸ *Ibid* para 1.7.

⁴⁹ *Ibid* para 1.5.

⁵⁰ ATO Tax Practitioners Forum Issues Log (register n, A27),

<www.ato.gov.au/taxprofessionals/contentasp?doc+/content/39983.htm&page=165&H28_1> on 29/11/06.

⁵¹ Former subdiv 328-C. Note that taxpayers who joined the STS prior to 30 June 2005 can still use the cash accounting system.

⁵² s 82KZM ITAA 1936.

⁵³ Subdiv 328-D ITAA 1997.

⁵⁴ Subdiv 328-E.

⁵⁵ *A Tax System Redesigned* above n 6, 575-586.

various taxation laws. The STS definition of a small business was different from that utilised by the GST,⁵⁶ capital gains tax⁵⁷ and fringe benefits tax⁵⁸ concessions for small business.

The STS proved to be inflexible and complex. The inflexibility of the STS was evident in the mandatory application of the cash accounting, prepayment and capital allowance concessions.⁵⁹ This would mean that taxpayers would have to make an annual overall calculation of the net benefit from these concessions to work out whether they should join or remain in the STS.⁶⁰

Further, under the STS, taxpayers were required to make an election to join or to leave the STS.⁶¹ As discussed below, joining or leaving the STS involved significant compliance costs associated with ascertaining eligibility and estimating the benefits of joining or leaving the STS.⁶²

1 STS Eligibility Criteria

Small business taxpayers could elect to join the STS from 1 July 2001, in the income year when the taxpayer became eligible to be an STS taxpayer,⁶³ and up to 30 June 2007 when the system was replaced by the SBE regime. The STS applied to all entities (individuals, partnerships, trusts and companies).⁶⁴ A STS taxpayer must have satisfied the following three small business requirements in a particular income tax year, as well as notifying the Commissioner of their choice to enter the STS in a particular income tax year.

Under the first requirement, the taxpayer must have carried on a business during the year,⁶⁵ thus passive investors were excluded. Ascertaining whether a taxpayer carried on a business could be very difficult. There is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up a number of relevant factors.⁶⁶ This approach creates considerable difficulties for taxpayers with small hobby-type activities that have some elements of business and lifestyle characteristics. Consequently, the vagueness of this definition has resulted in a plethora of cases⁶⁷ on business activity and a number of taxation rulings from the ATO.⁶⁸

The second requirement stipulated that the year's STS average turnover of an STS taxpayer and its grouped entities must have been less than \$1,000,000 net of GST

⁵⁶ Div 188 *A New Tax System (Goods and Services Tax) Act 1999* (GSTA), in relation to the small business cash accounting concession.

⁵⁷ Subdiv 152-A ITAA 1997, in relation to the small business CGT concession.

⁵⁸ s 58GA *Fringe Benefits Tax Assessment Act 1986*, in relation to the small business car parking fringe benefit concession.

⁵⁹ *A Tax System Redesigned* above n 6, 575-577.

⁶⁰ Former subdiv 328-F ITAA 1997.

⁶¹ Former subdiv 328-G.

⁶² Former subdivs 328-F, 328-G.

⁶³ Former s 328-435.

⁶⁴ Former s 328-365.

⁶⁵ Former s 328-365(1)(a).

⁶⁶ *Evans v FCT* (1989) 20 ATR 922; AAT CASE 12,860 *Re DAFF and FCT* (1998) 39 ATR 1042.

⁶⁷ *Martin v FCT* (1953) 90 CLR 470; *Ferguson v FCT* 79 ATC 4261; *FCT v Walker* 85 ATC 4179; *FCT v Stone* 2005 ATC 4234; *Puzey v FCT* [2002] FCA 1171; *FCT v Sleight* [2004] FCAFC 94.

⁶⁸ TR 97/11 'Income tax: Am I carrying on a Business of Primary Production?'; TR 2005/1 'Income tax: carrying on business as a professional artist'; TR 2003/4 'Income Tax: Boat hire arrangements'.

credits and decreasing adjustments.⁶⁹ Note this threshold was increased to \$2,000,000 from 1 July 2007 with the advent of the SBE regime.⁷⁰ This grouping rule prevented large businesses from splitting or restructuring into numerous entities so they were eligible to join the STS.⁷¹ Given its low turnover threshold, the STS favoured small business. Successful STS businesses were penalised though as they grew in size they were no longer eligible for the STS concessions. These eligibility requirements contained intricate rules for defining STS group turnover, defining the value of the business supplies, calculating grouping of an entity's turnover, working out who is an STS affiliate, defining control and indirect control of an entity and working out STS group turnover.⁷² Unfortunately, the STS grouping rules differed from the grouping rules for GST and this greatly added to its complexity for small business groups.⁷³

Thirdly, the total adjustable values⁷⁴ of depreciating assets⁷⁵ held at year end by the STS taxpayer and its grouped entities and deductible under Div 40 or subdiv 328-D, must have been less than \$3,000,000⁷⁶ (up until 30 June 2007).⁷⁷ The limit on the total value of depreciating assets that an entity and its grouped entities could have at the end of an income year ensured that large entities with low turnovers in early years of operation, but with large investments in capital assets, were not eligible to enter the STS.⁷⁸

The complexity of the eligibility rules for small business is evident from the need to satisfy the above three requirements. In particular, the detailed turnover and grouping rules will impose significant compliance costs on many small businesses.

2 Entering and Leaving

Entry into the STS was optional and that choice was usually made by notifying the Commissioner in the taxpayer's income tax return.⁷⁹ Notice may also have been given in an objection⁸⁰ or in an income tax assessment amendment request.⁸¹ A taxpayer, who notified the Commissioner to join in an income year could not revoke entry in that income year.⁸² Once a taxpayer joined the STS, however, the cash accounting, prepayment and depreciation rules were mandatory.⁸³ Only the trading stock rules were optional.⁸⁴ As noted previously, as a system, the STS was inflexible given the mandatory application of most of its features.

Additionally, joining the STS involved significant compliance costs associated with ascertaining eligibility and estimating the benefits of joining the STS as noted

⁶⁹ Former s 328-365(1)(b).

⁷⁰ s 328-110(1)(b).

⁷¹ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 1.7.

⁷² s 328-365 – 328-380.

⁷³ s 328-365 – 328-380 ITAA 1997; Div 48 GST Act.

⁷⁴ s 40-85 ITAA 1997.

⁷⁵ s 40-30.

⁷⁶ Former s 328-365(1)(c).

⁷⁷ The former s 328-365(1)(c) was abolished on 1 July 2007 with advent of the SBE regime.

⁷⁸ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 2.7.

⁷⁹ Former s 328-435 ITAA 1997.

⁸⁰ *Ibid*; TD 2003/31 'Income tax: Simplified Tax System: can an entity notify the Commissioner of its choice to become, or stop being, an STS taxpayer for an income year, after it has lodged that year's income tax return?' para 1.3.4.

⁸¹ s 170(5) ITAA 1936.

⁸² TD 2003/31.

⁸³ Former s 328-105(1), s 328-175(1) ITAA 1997, s 82KZM(1) ITAA 1936.

⁸⁴ s 328-285 ITAA 1997.

previously. STS taxpayers also needed to adjust their accounting systems for the uptake of cash accounting, prepayment deductions, pooled depreciation and for the estimation of trading stock on hand if they chose the simplified trading stock rules. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income and hence income tax payable.

A taxpayer left the STS when the eligibility criteria did not apply in that particular year and the taxpayer notified the Commissioner, or when a taxpayer opted out and notified the Commissioner of a decision to leave the STS.⁸⁵ Notice of exiting the STS may have been given after the income tax year with an income tax assessment amendment request.⁸⁶

Accordingly, if a taxpayer left the STS because the business failed to satisfy the eligibility criteria or ceased to exist, then the taxpayer must exit the STS at the end of that income year.⁸⁷ In these situations, though, a taxpayer could immediately re-enter when the business satisfied the criteria⁸⁸ by applying to the Commissioner to rejoin the STS.⁸⁹

If a taxpayer chose to leave the STS the taxpayer needed to wait five years before re-entering and the taxpayer must have applied to the ATO to rejoin.⁹⁰ Additionally, that exit choice once made could not be revoked.⁹¹ The five-year period ran from the last income year in which the taxpayer was an STS taxpayer.⁹² The five-year rule did not apply to taxpayers re-entering who voluntarily exited before the 2005-06 income year.⁹³ The five-year rule, though, applied to taxpayers exiting in the 2005-06 income year.⁹⁴ Consequently, the STS five-year rule may have resulted in some game-playing as taxpayers rendered themselves ineligible for the STS so they did not have to wait five years to return.⁹⁵ However, with the introduction of the SBE regime on 1 July 2007 the five-year STS rule was abolished.⁹⁶

Leaving the STS conceivably created significant compliance costs associated with estimating the costs and benefits of leaving. In such circumstances, the accounting systems would have been altered for the non-STS environment. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income. Once in, an STS a taxpayer may have been unable to exit as a result of the income tax payable in doing so.

⁸⁵ s 328-440.

⁸⁶ TD 20003/31; s 170(5) ITAA 1936, note that a four year time limit applies.

⁸⁷ s 328-440(1)(b) ITAA 1997.

⁸⁸ See note at the former s 328-440(3).

⁸⁹ Former s 328-435.

⁹⁰ Former s 328-440(3).

⁹¹ TD 20003/29 'Income tax: Simplified Tax System: can an entity that has notified the Commissioner of its choice to stop being an STS taxpayer for an income year, later cancel that choice for that year'.

⁹² ATO ID 2003/38.

⁹³ *Income Tax (Transitional Provisions) Act 1997* (ITTPA) s32-440; Given the termination of mandatory cash accounting from 1 July 2005, this enables former STS taxpayers who left because of the cash accounting regime to immediately re-enter.

⁹⁴ Former s 328-440 ITAA 1997.

⁹⁵ Hine above n 5, 31.

⁹⁶ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007* para 4.32. Although, a similar five year exit requirement was introduced in the SBE depreciation regime, see para 5.7.3.

3 Other Issues

Additionally, STS taxpayers needed to adjust their accounting systems for the uptake or cessation of cash accounting, prepayment deductions, pooled depreciation and for the estimation of trading stock on hand if they chose the simplified trading stock rules. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income and hence income tax payable. Once in the STS, a taxpayer may not be able to afford to leave given the income tax consequences. Further, where a taxpayer chose to leave, the taxpayer then needed to wait five years before re-entering.⁹⁷

Some of the complexity arose from the way that the four STS income tax accounting concessions ignored the commercial reality that most small businesses use accruals accounting.⁹⁸ This meant that small business in the STS would have had to run and adjust for two sets of accounts, one for tax purposes and another for financial reporting purposes.

Then there was the high level of detail in the STS. This is evident in the eligibility requirements discussed above. Additionally, the STS provided highly detailed rules for its cash accounting, capital allowance and trading stock concessions.⁹⁹ This is also considered to be a structural flaw given that the STS was designed to simplify or lower compliance costs for small business.

Further, the STS favoured a minority of capital intensive small businesses given that the main concession involves temporary depreciation relief.¹⁰⁰ This is also a structural problem since the STS was designed to benefit the majority of small businesses yet it was poorly targeted. Additionally, the STS's aim of reducing the effective tax burden for small business was not achieved given the nature of the modest STS timing benefits from the temporary deferral of income tax and its unpopularity. A number of commentators queried the merits of these concessions finding that there were few (if any) simplicity benefits.¹⁰¹

C Phase One Reforms of the STS

In response to these concerns the federal Government implemented a series of amendments to the STS to make it more attractive to small business. The mandatory STS cash accounting basis created a number of problems for many small businesses that utilised accruals accounting and / or obtained little benefit from the concessions.¹⁰² Consequently, the system was abandoned from 1 July 2005.¹⁰³ STS

⁹⁷ Former s 328-440(3).

⁹⁸ ICAA Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000, notes that a recent survey had shown that between 60 and 75 per cent of small to medium business used accrual accounting.

⁹⁹ Former subdivs 328-C, 328-D, 328-E ITAA 1997, s 82KZM ITAA 1936.

¹⁰⁰ *A Tax System Redesigned* above n 6, 721. The *Review* estimated that the STS accelerated depreciation concession would be the most costly to tax revenue, with an estimated loss of in its first year of operation of \$240 million as opposed to the total revenue loss of \$520 m in that year.

¹⁰¹ Hine above n 5; Kenny above n 5; Snook above n 5; Wolfers, Miller above n 5; Martin above n 5; Douglas above n 5; Tretola above n 5; Bondfield above n 5; McKerchar above n 5.

¹⁰² Tretola above n 5, 14; Kenny 'A Simplified Tax System for Small Business' above n 5, 37; Snook above n 5, 77-78; Wolfers Miller above n 5, 376; Douglas above n 5, 11; Bondfield above n 5, 332-334.

¹⁰³ *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Sch 2.

taxpayers that joined before 1 July 2005 though can continue to use the cash accounting basis.¹⁰⁴

The STS capital allowance rules did not originally provide for any roll over relief (unlike the general depreciation regime in Div 40) for depreciating assets. To encourage the uptake of the STS,¹⁰⁵ optional roll-over relief was provided for partial changes in the ownership of an asset held by STS partnerships.¹⁰⁶ This change was applied retrospectively from the start of the STS, 1 July 2001.¹⁰⁷

Subsequently s 328-240 was repealed as result of new extended roll-over relief provisions contained in ss 328-243, 328-245 that applied from 1 July 2005. The requirement in the former s 328-240 that both entities must be partnerships was also changed. Only one of the entities needed to be a partnership under the new rules.¹⁰⁸

Additionally, new STS concessions were introduced with the STS exemption from the indirect value shifting rules,¹⁰⁹ the STS entrepreneurs discount¹¹⁰ and STS limited amendment periods.¹¹¹

In summary, whilst these amendments may have improved the attractiveness of the STS for small business these changes did not address the underlying structural problems in the STS. The amendments failed to provide an appropriate universal definition of a 'small business'. Further, a great deal of inflexibility and complexity remained with the three STS income tax accounting concessions. Additionally, these concessions continued to favour a minority of small businesses and only provided a timing benefit from the temporary deferral of income tax.

D Phase Two Reforms of the STS

On 12 October 2005 the Government established a taskforce chaired by Gary Banks (*Banks Taskforce*) to reduce the regulatory burden on small business.¹¹² The *Banks Taskforce's* report *Rethinking Regulation* was provided to the federal Government on 31 January 2006.¹¹³ The submissions to the *Banks Taskforce* called for a consistent definition of small business.¹¹⁴ The *Banks Taskforce* also found that there was a need to harmonise taxation law definitions and recommended that the definition of a small business be aligned or rationalised.¹¹⁵ Consequently, on 1 July 2007 the federal Government renamed and modified the STS in Div 328 as part of the new SBE regime¹¹⁶ so as to simplify tax law for small business.

¹⁰⁴ s 328-100 *Income Tax Transitional Provisions) Act 1997* (ITTPA 1997).

¹⁰⁵ Explanatory Memorandum, *Taxation Laws Amendment Act (No. 2) 2004* No. 20, para 7.5 states 'Roll-over relief is not currently available for reconstitutions of partnerships operating under the STS (i.e. STS partnerships), deterring some taxpayers from joining the STS. This measure will allow optional roll-over relief for STS partnerships subject to certain conditions.'

¹⁰⁶ The former s 328-240 ITAA 1997.

¹⁰⁷ *Ibid.*

¹⁰⁸ s 328-243.

¹⁰⁹ s 727-470.

¹¹⁰ Subdiv 61-J.

¹¹¹ s 170(1) ITAA 1936.

¹¹² Taskforce on Reducing the Regulatory Burden on Business (Chairman, Gary Banks) *Rethinking Regulation* 31 January 2006, <http://www.regulationtaskforce.gov.au/finalreport/>.

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid* 169-170, Recommendation 5.43.

¹¹⁶ *Tax Laws Amendment (Small Business) Act 2007*.

III THE SMALL BUSINESS ENTITIES RULES

Helpfully for small business the new SBE definition of a small business aligned a number of small business taxation definitions.¹¹⁷ Apart from the former STS income tax accounting concessions, the SBE test applies to the following small business concessions:¹¹⁸

- CGT 15-year asset exemption subdiv 152-B;
- CGT 50% active asset reduction subdiv 152-C;
- CGT retirement exemption subdiv 152-D;
- CGT roll-over subdiv 152-E;
- Accounting for GST on a cash basis s 29-40 GSTA 1999;
- Annual apportionment of input tax credits for acquisitions and importations that are partly creditable s 131-5 GSTA 1999;
- Paying GST by quarterly instalments s 162-5 GSTA;
- FBT car parking exemption s 58GA of the FBTA 1986;
- PAYG instalments based on GDP-adjusted notional tax s 45-130 of Schedule 1 TAA 1953;
- Standard 2-year period for amending your assessment applies under s 170 ITAA 1936.

Additionally, these rules provide greater flexibility for small business. From 1 July 2007, SBE have the choice to apply any of the above SBE concessions since they are no longer compulsory,¹¹⁹ unlike most of the former STS concessions.¹²⁰ Under the SBE rules there is no need to lodge an election with the Australian Taxation Office to access the concessions and this would also reduce compliance costs.¹²¹ The former \$1 million STS average turnover threshold¹²² was replaced with a \$2 million aggregate turnover threshold¹²³ and the former STS \$3 million depreciating assets test was abolished.¹²⁴

The increase in the turnover threshold though will lead to some inequity as the larger small businesses will gain the most from the SBE regime. The removal of the depreciating asset limit requirement improves simplicity but structurally damages the integrity of the SBE definition of a small business. Under this SBE definition large and medium sized businesses (such as start up mining companies) will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold.

Amendments were made to the above concessions to introduce the new term of SBE and to replace all former small business references (such as 'STS taxpayers'). However, some of the above concessions impose alternative tests to the SBE requirements. This undermines the simplicity benefit that could have been achieved from having a single definition of small business.¹²⁵ For example, the small business

¹¹⁷ Subdiv 328-C ITAA 1997.

¹¹⁸ s 328-10(1). Note that the concessions (dot pointed above) are outside the scope of this paper which focuses on the SBE income tax accounting concessions (the prepayment, depreciation and trading stock concessions).

¹¹⁹ s 328-110(1).

¹²⁰ Former subdivs 328-C, 328-D ITAA 1997, s82KZM ITAA 1936.

¹²¹ Subdivs 328-D, 328-E ITAA 1997, s82KZM ITAA 1936.

¹²² Former s 328-365(1)(b) ITAA 1997.

¹²³ s 328-110(1)(b).

¹²⁴ s 328-110(1).

¹²⁵ Hodgson H, 'Small business simplification – yet again?' (2007) 11 *The Tax Specialist* 140, 140.

capital gains tax concessions utilise an alternative \$6 million net assets test.¹²⁶ This breaches the *Review's* recommendation of an integrated tax code having 'a common dictionary to ensure consistency and greater standardisation of concepts across the Code'.¹²⁷

The former STS entry and exit rules in subdivs 328-F and 328-G were repealed as they are unnecessary under the fully optional SBE regime.¹²⁸ Complex transitional rules, though, were introduced to cater for the move from the STS to the SBE regime.¹²⁹

A Defining SBE

The SBE regime shares similar levels of complexity with the STS, with its complex annual eligibility criteria and aggregation rules.¹³⁰ An entity is a SBE if it carries on a business¹³¹ and satisfies the \$2 million aggregated turnover test¹³² as set out in the flow chart at figure 1.¹³³

1 Aggregated turnover test

The intricacy of the above flow chart is indicative of the complexity involved with the new SBE requirements. The flow chart shows how an entity will satisfy the \$2 million aggregated turnover test if any of the following three requirements are satisfied.¹³⁴

- the entity's aggregated turnover for the previous income year was less than \$2 million,¹³⁵
- the entity's aggregated turnover for the current income year is likely to be less than \$2 million, calculated as at the first day of the income year;¹³⁶ or
- the entity's actual aggregated turnover for the current income year was less than \$2 million, calculated as at the end of the income year.¹³⁷

A few modifications apply to the second and third criteria. The second requirement excludes businesses that have aggregated turnovers of more than \$2 million in each of the two income years before the current year.¹³⁸ SBE that only satisfy the third requirement are further restricted as they cannot choose the concessions for PAYG instalments,¹³⁹ GST cash accounting,¹⁴⁰ annual apportionment of input tax credits,¹⁴¹ or GST quarterly instalment concessions.¹⁴² This all means that small business will

¹²⁶ s 152-15.

¹²⁷ *A Tax System Redesigned* above n 6, 129.

¹²⁸ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007* para 4.33.

¹²⁹ *Tax Laws Amendment (Small Business) Act 2007* pp 49-56.

¹³⁰ Hodgson above n 94, 137

¹³¹ s 328-110(1)(a).

¹³² s 328-110(1)(b).

¹³³ Explanatory Memorandum, *Tax Laws Amendment (Small Business) Act 2007*, Diagram 1.1, 9.

¹³⁴ s 328-110.

¹³⁵ s 328-110(1)(b)(i).

¹³⁶ s 328-110(1)(b)(ii), 328-110(2).

¹³⁷ s 328-110(4).

¹³⁸ s 328-110(3).

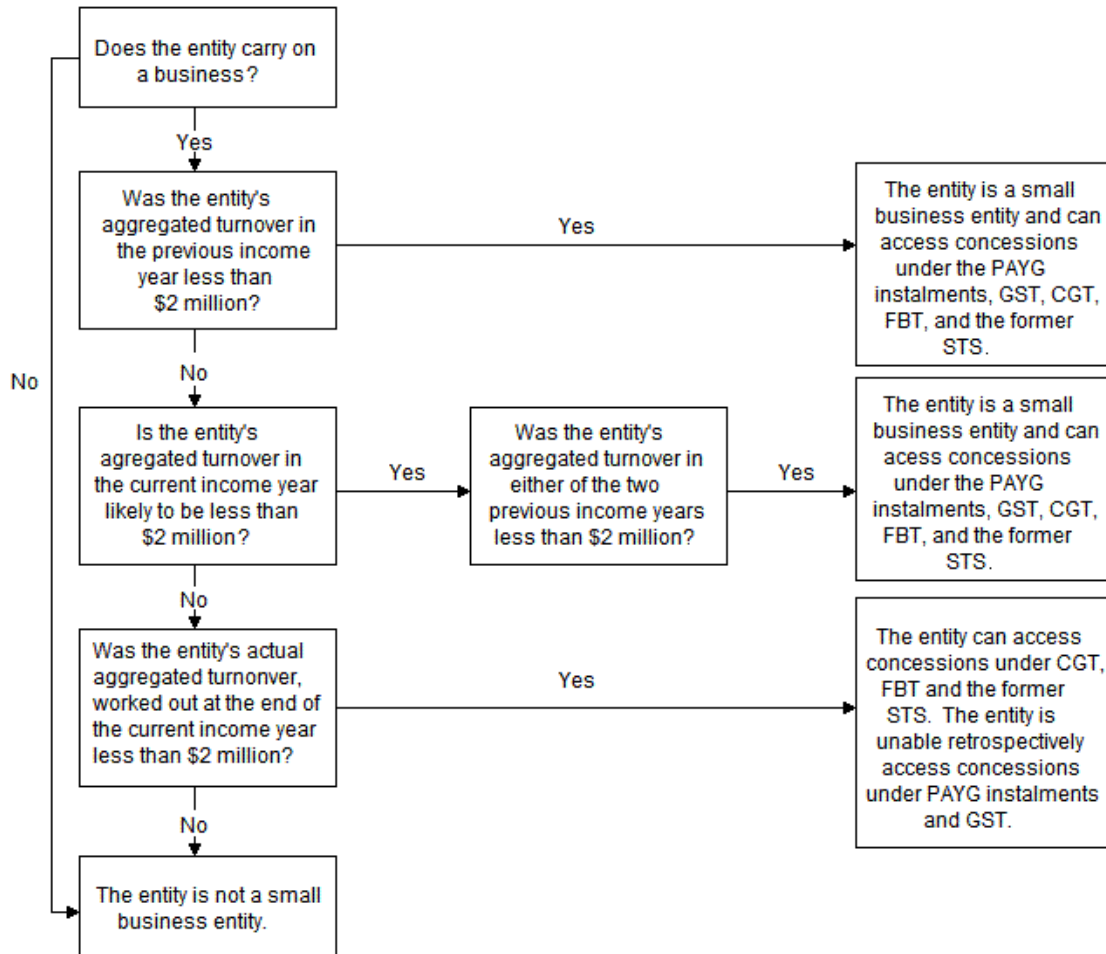
¹³⁹ s 45-130 of Sched 1 *Taxation Administration Act 1953*.

¹⁴⁰ s 29-40 GSTA.

¹⁴¹ s 131-5 GSTA.

¹⁴² s 162-5 GSTA

Figure 1: Defining a Small Business Entity
Explanatory Memorandum, Tax Laws Amendment (Small Business) Act 2007,
Diagram 1.1



have to closely pay attention to these requirements to ensure that they are first eligible and secondly, that they satisfy at least one of the first two criteria so as to maximise their benefits under SBE regime.

2 Aggregated turnover

Aggregated turnover consists of an entity’s annual turnover plus the turnover of all other entities that need to be aggregated with it.¹⁴³ Working out aggregated turnover involves calculating an entity’s annual turnover, then applying the aggregation rules and finally adding up the aggregated turnover. Aggregated turnover excludes transactions between connected or affiliated entities.¹⁴⁴

¹⁴³ s 328-115(1),(2) ITAA 1997. Thus an entity's aggregated turnover will be the same as its annual turnover if no other entities are aggregated.

¹⁴⁴ s 328-115(3).

3 Annual turnover

An entity's annual turnover for an income year is generally the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business¹⁴⁵ excluding amounts that relate to GST¹⁴⁶ and amounts derived from sales of retail fuel.¹⁴⁷ Any ordinary income that an entity derives from any dealing with an associate of the entity is stipulated as the amount of ordinary income the entity would derive from the dealing as if it were at arm's length.¹⁴⁸

If a business is carried on for part of the income year only, the entity's annual turnover for the income year must be worked out using a reasonable estimate of what the entity's annual turnover for the income year would be if the entity carried on a business for the whole of the income year.¹⁴⁹ Regulations may allow a different calculation of annual turnover for particular entities.¹⁵⁰ The annual turnover exclusions and the need to make estimates for part year activities both add to the complexity of the SBE regime.

4 Aggregation Rules

The annual turnover of other entities needs to be aggregated with an entity if it is an affiliate of another entity, or if it is connected with another entity.¹⁵¹

(a) Affiliate

An individual or company is an affiliate of an entity where that individual or company acts, or could reasonably be expected to act in accordance with the entity's directions or wishes in relation to the affairs of that individual or company's business, or in concert with the entity in relation to the affairs of the individual or company's business.¹⁵² An individual or a company, though, is not an affiliate of an entity merely because of the nature of the business relationship the entity and the individual or company shares.¹⁵³

(b) Connected with another entity

An entity is connected with another entity if one of the entities controls the other entity, or if the two entities are controlled by the same third entity.¹⁵⁴ The control rules apply first to all entities except discretionary trusts.¹⁵⁵ Further rules apply to discretionary trusts.¹⁵⁶

¹⁴⁵ s 328-120(1).

¹⁴⁶ s 328-120(2).

¹⁴⁷ s 328-120(3).

¹⁴⁸ s 328-120(4): Amounts derived in an income year from any dealings between an entity and an associate that is a relevant entity within the meaning of section 328-115 are not included in the entity's aggregated turnover for that year: see subsection 328-115(3).

¹⁴⁹ s 328-120(5).

¹⁵⁰ s 328-120(6).

¹⁵¹ s 328-115(2).

¹⁵² s 328-130(1).

¹⁵³ s 328-130(2).

¹⁵⁴ s 328-125(1).

¹⁵⁵ s 328-125(2).

¹⁵⁶ s 328-125(3).

For entities other than discretionary trusts, an entity controls another entity where the first entity or its affiliates, or the first entity and its affiliates between them beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that between them give the right to receive at least 40 per cent of any distribution of either income or capital.¹⁵⁷

For control of companies an alternative test applies. Where an entity alone or together with affiliates beneficially own, or has the right to acquire beneficial ownership of, interests in the company with at least 40 per cent of the voting power in the company then the entity will control the company.¹⁵⁸

An entity can control a discretionary trust in the following two situations. First, under the 40 per cent ownership test¹⁵⁹ an entity is taken to control a discretionary trust for an income year if, for any of the four income years before that income year the trustee paid any income or capital of the trust to or for the benefit of the first entity, its affiliates, or the first entity and its affiliates¹⁶⁰ and the amount paid or applied to the entity and/or its affiliates is at least 40 per cent of the total amount of income or capital paid or applied by the trustee for that income year.¹⁶¹ Secondly, control of a discretionary trust will occur where the trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the entity.¹⁶²

An indirect control test also applies to all entities. If an entity (the first entity) directly controls a second entity, and that second entity also controls (whether directly or indirectly) a third entity, the first entity is taken to control the third entity.¹⁶³

Special rules may apply where an entity's interest in another entity is at least 40 per cent but less than 50 per cent. In this situation the Commissioner may choose to ignore the interest of that entity in the other entity if the Commissioner determines that a third entity actually controls the other entity.¹⁶⁴

The above overview of the SBE aggregation rules demonstrates a high level of complexity as seen in the former STS grouping provisions. Under the SBE regime changes have been made from the former STS small business definitions of turnover and slight changes have been made to the control tests. Hodgson notes that the SBE aggregation rules provide some minor improvement over the former STS rules.¹⁶⁵ Overall, these SBE rules are very difficult for small business to understand as evident in the 62 paragraphs of explanation provided in the Explanatory Memorandum accompanying these changes.¹⁶⁶

B *Prepaid Expenses*

For SBE taxpayers that choose the SBE prepayments rules, prepayments are immediately deductible if the eligible service period (the period of the benefit) of the

¹⁵⁷ s 328-125(2)(a).

¹⁵⁸ s 328-115(2)(b).

¹⁵⁹ s 328-125(4).

¹⁶⁰ s 328-125(4)(a).

¹⁶¹ s 328-125(4)(b).

¹⁶² s 328-125(3).

¹⁶³ s 328-125(7).

¹⁶⁴ s 328-125(6).

¹⁶⁵ Hodgson above n 125, 136-137. Noting that the control tests in relation to partnerships have been simplified.

¹⁶⁶ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007*, paras 1.11 – 1.73.

prepayment is 12 months or less and where the prepayment is otherwise deductible under s 8-1 ITAA 1997 or ss 73B, 73BA, 73BH or 73Y ITAA 1936.¹⁶⁷ Where the prepayments do not meet this requirement s 82KZM applies to pro rata deductions over the lesser of eligible service period or 10 years.

There are a number of exceptions to this general rule. An immediate deduction is available to all taxpayers (including SBE) for any excluded expenditure.¹⁶⁸ Excluded expenditure includes: expenses of less than \$1,000, expenses required to be incurred by law,¹⁶⁹ or by an order of a court or expenses of salary or wages made under a contract of service.¹⁷⁰ Tax shelter¹⁷¹ and plantation forestry operation prepayments¹⁷² are governed by their own prepayment regimes.

1 *Further Issues*

The STS / SBE prepayment rules were introduced to strengthen the rules for prepaid expenses¹⁷³ and to provide simplification benefits.¹⁷⁴ Rather than strengthen income tax law, these prepayment rules breach the principles for prepayments laid down in the *Review's* recommendations, namely, that prepaid expenses should be amortised over the period of benefit.¹⁷⁵ Whilst the prepayment rules provide SBE with a small timing benefit from the deferral of income tax and remove the need to account for certain prepayments as assets, it is not clear that there are any significant simplification benefits. This is seen by the way that these rules contradict accounting practices that require the accrual of prepaid expenses over the period in which the income that was directly related to those expenses was earned.¹⁷⁶ This may increase compliance costs as taxpayers would have needed to adjust their accounting records given the immediate deduction obtained for prepaid expenses for income tax purposes.

C Capital Allowances

SBE can opt to calculate deductions for their depreciating assets in accordance with subdiv 328-D,¹⁷⁷ rather than the general depreciation rules in Div 40. Under the SBE regime, depreciating assets are depreciated by using a pool as a single depreciating asset.¹⁷⁸ There are two types of pools. A general small business pool for depreciating assets with an effective life of less than 25 years¹⁷⁹ and a long life small business pool for depreciating assets with an effective life of 25 years or more.¹⁸⁰ An

¹⁶⁷ Ibid.

¹⁶⁸ s 82KZM(1)(b) ITAA 1936.

¹⁶⁹ ATO ID 20046/218 prepaid fees incurred by a company for the audit of its financial reports, were not an amount of expenditure required to be incurred by a law of the Commonwealth, a State or a Territory and thus not 'excluded expenditure.

¹⁷⁰ s 82KZL(1).

¹⁷¹ s 82KZME. The tax shelter rules require that the prepayment be amortised over the period during which the thing is to be done under the arrangement (the eligible service period).

¹⁷² s 82KZMG.

¹⁷³ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 7.9.

¹⁷⁴ Ibid para 8.19.

¹⁷⁵ *A Tax System Redesigned* above n 6, 168-172.

¹⁷⁶ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

¹⁷⁷ s 328-175(1) ITAA 1997.

¹⁷⁸ s 328-185(1).

¹⁷⁹ s 328-185(2)(a).

¹⁸⁰ s 328-185(2)(b).

immediate write-off applies to depreciating assets costing less than \$1,000¹⁸¹ The *Review* argued that the simplified depreciation regime would mean substantial savings in compliance costs from the lesser record keeping in pooling assets and from the simpler rules for disposing of depreciating assets.¹⁸²

The SBE capital allowance rules helpfully retain many of the definitions used in the general capital allowance rules in Div 40, such as: depreciating asset,¹⁸³ effective life,¹⁸⁴ taxable purpose,¹⁸⁵ cost,¹⁸⁶ adjustable value,¹⁸⁷ low cost asset,¹⁸⁸ balancing adjustment event¹⁸⁹ and termination value.¹⁹⁰

1 Excluded Assets

Assets excluded from depreciation deductions under the general depreciation regime by s 40-45 are excluded from the SBE rules as well.¹⁹¹ This includes capital works deductible under Div 43, expenditure on certain IRUs¹⁹² relating to international submarine cables and film expenditure deductible under Div 10BA in Pt III of ITAA 1936 or film copyright expenditure under Div 10B in Pt III of ITAA 1936.¹⁹³ Additionally, horticultural plants are excepted.¹⁹⁴

Assets let or that are reasonably expected to be let predominantly on depreciating asset leases are excluded as well.¹⁹⁵ ATO Interpretive Decision ID 2004/651 provided guidance on the time at which it is necessary to determine, in respect of an asset that has not yet been let, whether there was a reasonable expectation that it would be let predominantly on a depreciating asset lease. For an asset held before joining the SBE, this decision must have been made in the first SBE year. If the asset was acquired whilst a SBE taxpayer, the decision must have been made at the end of the year of acquisition.

Assets placed in a low value pool under subdiv 40-E, or to a pool under former subdiv 42-L before the holder became a SBE are excepted.¹⁹⁶ Expenditure on in-house software allocated to a software development pool under subdiv 40-E is excluded as well.¹⁹⁷ Thus for software development pools used by taxpayers prior to entering the STS / SBE regimes, any future software development expenditure must

¹⁸¹ s 328-180(1).

¹⁸² *A Tax System Redesigned* above n 6, 582.

¹⁸³ s 40-30.

¹⁸⁴ ss 40-95 to 40-110.

¹⁸⁵ s 40-25(7).

¹⁸⁶ Subdiv 40-C.

¹⁸⁷ s 40-85.

¹⁸⁸ s 40-425(2).

¹⁸⁹ Subdiv 40-D.

¹⁹⁰ s 40-300.

¹⁹¹ s 328-175(2); ATO ID 2004/481 found that an STS taxpayer who built a farm shed on pastoral land could pool the construction expenditure in an STS pool as the shed constituted plant under Div 40.

¹⁹² s 995-1, an IRU is an indefeasible right to use a telecommunication cable system.

¹⁹³ s 40-45.

¹⁹⁴ s 328-175(5).

¹⁹⁵ s 328-175(6); Thus depreciating assets used in rental properties are excluded from the subdiv 328-D since the assets are part of property that is subject to a depreciating asset lease; In ATO ID 2003/375 an STS taxpayer could not claim a deduction under ss 328-180(1) or s 328-185 for an appliance, as the appliance was being let predominantly on depreciating asset lease rather than short-term hire agreement.

¹⁹⁶ s 328-175(7).

¹⁹⁷ *Ibid.*

continue to be allocated to the software development pool.¹⁹⁸ However, if a SBE taxpayer did not have a software development pool upon entry to the SBE then any new software development expenditure is deducted under a software development pool under Div 40, or the depreciating asset and the software are allocated to a small business pool.¹⁹⁹ Further, research and development assets depreciated under s 73BA of ITAA 1936, or for which a tax offset is chosen under s 73I are excluded.²⁰⁰

Additionally, SBE can choose whether the SBE capital allowance regime applies to the following assets. Primary producers in the SBE regime using depreciating assets which are deductible under subdiv 40-F or subdiv 40-G ITAA 1997 can choose between claiming deductions under those subdivisions or under subdiv 328-D.²⁰¹ This choice must be made in respect of each depreciating asset in respect of the first income year in which the taxpayer entered, or last joined the SBE regime, or in respect of the first year of use of the asset.²⁰² This choice is irrevocable.²⁰³ Where a transferor partnership makes a choice under s 328-175(3) for an asset, this choice also applies to the transferee partnership if roll-over relief under s 328-240 is chosen.²⁰⁴

In making these choices for subdiv 40-F or subdiv 40-G primary production assets, a SBE taxpayer needs to compare the depreciation deductions to those available under SBE so as to ascertain the optimal taxation position. However, the number of these exclusions and their optionality results in considerable complexity for small business especially where two or more methods of depreciation are utilised.

2 Low cost assets

The taxable (business) purpose proportion of the adjustable value of a low cost asset is immediately deductible for SBE.²⁰⁵ A low cost asset is a depreciating asset whose total cost is less than \$1,000 as at the end of the income year in which the taxpayer started to use it, or had it installed ready for use, for a taxable purpose.²⁰⁶ The taxpayer, though, must have been a SBE in the year of the deduction and in the year in which the taxpayer started to hold the asset.²⁰⁷

The taxable purpose proportion of the second element costs of low cost assets is immediately deductible where the taxpayer deducts an amount under s 328-180(1).²⁰⁸ A second cost element is the amount the taxpayer is taken to have paid to bring the asset to its present condition and location.²⁰⁹ The second element amount must be less than \$1,000 and the taxpayer must have started to use the asset, or had it installed ready for use, for a taxable purpose during an earlier income year.²¹⁰

Second cost elements of low-cost assets deducted under s 328-180 are allocated to the general small business pool in two situations.²¹¹ First, the costs are allocated

¹⁹⁸ Ibid See Note.

¹⁹⁹ s 328-175(8).

²⁰⁰ s 328-175(9).

²⁰¹ s 328-175(3).

²⁰² s 328-175(4).

²⁰³ Ibid.

²⁰⁴ s 328-245(3).

²⁰⁵ s 328-180(1).

²⁰⁶ s 40-425(2).

²⁰⁷ s 328-180(1).

²⁰⁸ s 328-180(2).

²⁰⁹ s 40-190.

²¹⁰ s 328-180(2).

²¹¹ s 328-180(3).

where the second element of the asset's cost exceed \$1,000.²¹² Secondly, where any amount is included in the second element of the asset's cost and the taxpayer deducts or could have deducted an amount under s 328-180(2) for an amount previously included in the second element of the asset's cost.²¹³

When a low cost asset that has been immediately written off is subject to a balancing adjustment event,²¹⁴ then the termination value²¹⁵ of the asset is included in the taxpayer's assessable income, to the extent of the business use.²¹⁶

Since immediate SBE deductions for low cost assets are restricted to assets acquired when a taxpayer is a SBE taxpayer,²¹⁷ then any low cost assets acquired prior to that time and allocated to a Div 40 low value pool²¹⁸ remain in that pool.²¹⁹ This write off is helpful for small business as it excludes many of their depreciating assets from taxation depreciation schedules. This benefit, though, is offset by the need to produce financial accounting reports that require depreciation schedules.²²⁰

3 Pooled Depreciating Assets

Depreciating assets with less than a 25 year effective life²²¹ are allocated to the general pool and use an accelerated diminishing value depreciation rate of 30 per cent.²²² Depreciating assets with an effective life longer than 25 years²²³ are allocated to the long life pool and use an accelerated diminishing value depreciation rate of 5 per cent.²²⁴ As discussed above, the use of two pools may simplify depreciation for certain small businesses.

However, much complexity is inherent in the pooling rules.²²⁵ Once the allocation is made to the pool this is irrevocable.²²⁶ Further, when a taxpayer leaves the SBE regime and subsequently re-enters, the assets remain in the pool.²²⁷ Depreciating assets acquired by the taxpayer outside of the SBE rules, though, can not be allocated to the pools until the taxpayer re-enters.²²⁸ Further, as noted above, under the pools a number of assets are excluded and other assets are optional under the SBE. This means that small businesses have to determine the optimal depreciation method and they may need to employ two or more methods of depreciation calculation. This adds to complexity.

²¹² s 328-180(3)(a).

²¹³ s 328-180(3)(b).

²¹⁴ s 40-295.

²¹⁵ s 40-300.

²¹⁶ s 328-215(4).

²¹⁷ Unless the item is 100 per cent deductible for a non-business taxpayer under s 40-80(2).

²¹⁸ Subdiv 40-E.

²¹⁹ s 328-180(1).

²²⁰ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²²¹ ss 328-185(2)(a), (3), (4), s 328-180(3); ATO ID 2004/209 advises that a taxpayer should allocate a pre STS long life asset to their long life pool for the purposes of s328-185 where that asset has a remaining effective life of less than 25 years.

²²² s 328-190(1)(a).

²²³ ss 328-185(2)(b), (3),(4),(5),(6).

²²⁴ s 328-190(1)(b).

²²⁵ Hine above n 5, 34; Bondfield above n 5, 331-332; Kenny above n 5, 40; McKerchar above n 5, 142-144.

²²⁶ s 328-185(7).

²²⁷ s 328-220(1).

²²⁸ s 328-220(2).

4 Pool Depreciation Calculations

SBE can claim a capital allowance deduction for a depreciating asset they hold and start to use or have installed ready for use, for a taxable purpose during or before the income year.²²⁹ A deduction for pooled depreciation for an income year is based on the opening pool balance multiplied by the pool rate for the general pool and the long life pool.²³⁰ Depreciating assets and second element costs added by a SBE taxpayer during the income year to the general pool attract a 15 per cent rate and additions to the long life pool attract a 2.5 per cent rate.²³¹ This, though, provides scope for manipulation given the significant accelerated depreciation tax deduction for depreciating assets acquired (or second cost amounts incurred) on or near the end of the income tax year.

5 Opening Pool Balance

When a taxpayer enters the SBE regime the opening pool balance is the sum of the taxable purpose proportions of the adjustable values of each depreciating asset held immediately prior to joining.²³² However, a problem occurs for taxpayers with capital gains on pre 21 September 1999 depreciable assets as they lose any indexation benefit when placed into the SBE depreciation pool.²³³ Another problem arises for assets allocated to an SBE pool since they can not be included in the value of assets for the purposes of the NCL 'Other assets' test in s 35-45 (as the table in s 35-45(2) only lists assets deductible under Div 40). These rules work to deter small businesses from entering the SBE regime.

The opening pool balance for the next income year is the taxpayer's closing pool balance from the previous income year, unless an adjustment is made for a variation in the taxable use of an asset.²³⁴

For taxpayers who leave the SBE and re-enter, any assets acquired in the absence from the SBE are added into the pool upon re-entry.²³⁵ Thus the opening pool balance is the closing balance from the previous year plus the taxable purpose proportion of the adjustable values²³⁶ of assets used for a taxable purpose when absent from the SBE rules.²³⁷

²²⁹ s 328-175(1); In ATO ID 2004/208 an STS taxpayer was not able to claim a capital allowance deduction for a depreciating asset they previously leased, and subsequently acquired seconds before they sold the asset, as the asset was not used or installed ready for use, in the year in question per s 328-175(1).

²³⁰ s 328-190(1)

²³¹ ss 328-190(2)-(4).

²³² s 328-195(1).

²³³ s 118-24(1) exempts Div 328 depreciating assets from the capital gains tax rules. Thus the SBE depreciation rules will govern the assessability of the disposal of such SBE depreciating assets.

²³⁴ s 328-195(2).

²³⁵ s 328-195(3).

²³⁶ s 40-85.

²³⁷ Ibid.

6 *Estimate of Taxable Use*

Subsequent to joining the SBE depreciation regime, a taxpayer must make a reasonable estimate of the taxable use of assets added to the pools.²³⁸ If the estimate of taxable purpose is more than 10 per cent different from the most recent estimate, the taxpayer needs to change the opening pool balance accordingly.²³⁹ Considerable complexity arises when a change in the business use of a depreciating asset occurs. For example, s 328-225(4)(a) provides the following complex formula:²⁴⁰

(4) The reduction factor in the formula in subsection (3) is:

(a) for a depreciating asset you started to use, or have installed ready for use, for a taxable purpose while you were an STS taxpayer:

$$[1 - (\text{rate}/2)] \times [1 - \text{rate}]^{n-1}$$

This variation though is not required in a general pool if the change in taxable purpose occurred three years or more after the income year in which the asset was allocated to the pool.²⁴¹ For long life pools the variation is not required if the change in taxable purpose occurred twenty years or more after the income year.²⁴² Averaging rules apply for calculating the taxable purpose proportion of a depreciating asset's termination value according to whether the asset was allocated to a general or long life pool.²⁴³ As this overview shows, such individual calculations offset the compliance cost benefits of pooling assets.²⁴⁴

7 *Closing Pool Balance*

The closing pool balances for the two pools are calculated as the opening pool balances for the income year and adding the business use proportion of the adjustable value of new asset additions or improvements first used in that year, less the following amounts.²⁴⁵ The business use proportion of the termination value of pooled depreciating asset disposed in the income year; the s 328-190(1) deductions allowed for the pool's depreciation for the income year; and the deductions for depreciation on an asset or improvement to the pool and first used, or installed ready for use, for a taxable purpose in that year.²⁴⁶ This provides for a simpler depreciation calculation since calculations do need to be made for individual assets (unless the assets are excluded and subject to another depreciation regime, or have an element of non-

²³⁸ s 328-205(1), 328-225; ATO ID 2004/89 provides that an STS taxpayer estimates the taxable use proportion of a pre STS asset under s 328-205 at the end of the income year the asset is allocated to an STS pool.

²³⁹ s 328-225(1A).

²⁴⁰ Wolfers Miller above n 5, 374, the authors stated 'Maybe for a mathematically gifted small business operator, a formula such as this provides no challenge. However, for the average lawyer with a limited mathematical knowledge, it is not so simple.'

²⁴¹ s 328-225(5)(a)(i).

²⁴² s 328-225(5)(a)(ii).

²⁴³ s 328-205(4).

²⁴⁴ Also, see McKerchar above n 5, 143.

²⁴⁵ s 328-200.

²⁴⁶ Ibid.

business use). This benefit, though, is offset by the need to produce financial accounting reports that require individual calculations.²⁴⁷

8 Low Value Pool Write Off

If the value of the small business pool was \$1,000 or lower then the balance is immediately deductible.²⁴⁸ This value is determined by the pool's opening value plus the business proportion of assets acquired during the income year and deducting the business proportion of assets disposed during the income year.²⁴⁹ This will simplify tax depreciation for micro businesses that have very few low cost assets. Again, this benefit is offset by financial accounting requirements that require depreciation schedules.²⁵⁰

9 Asset Disposals

Upon the disposal of a low cost depreciating asset (costing less than \$1,000), the business proportion of the asset's termination value must be returned as income.²⁵¹

In relation to the disposal of pooled assets the business proportion of the asset's termination value must be subtracted from the pool balance at the end of the income year.²⁵² If the disposal produces a negative pool balance then this amount is included as assessable income in that income year²⁵³ and the closing pool balance is zero.²⁵⁴

This will simplify tax depreciation for small business where there is a disposal of an asset given that a balancing adjustment²⁵⁵ will not need to be calculated. However, this benefit is offset by financial accounting requirements that require depreciation schedules.²⁵⁶

10 Leaving the SBE regime

When a taxpayer leaves the SBE depreciation regime the entity must wait five years after opting out to re-enter.²⁵⁷ If an entity chooses to use subdiv 328-D, the entity must retain the small business pools even after the entity stops being a SBE or chooses not to use subdiv 328-D.²⁵⁸ This lack of flexibility offsets the simplification benefits.

²⁴⁷ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁴⁸ s 328-210(1).

²⁴⁹ s 328-210(2).

²⁵⁰ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁵¹ s 328-215(4).

²⁵² s 328-215(2); ATO ID 2004/363 provides that s40-370 does not apply to STS taxpayers that sell a car for which car expense deductions have been calculated under Div 28 using the one-third of actual expenses method and the 12 per cent of original value method for different income years, rather the STS rules in subdiv 328-D apply.

²⁵³ *Ibid.*

²⁵⁴ s 328-215(3).

²⁵⁵ s 40-295.

²⁵⁶ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁵⁷ s 328-175(10).

²⁵⁸ s 328-185(7) see note, s 328-220.

11 *Further Issues*

The STS / SBE depreciation regime was designed to reduce compliance costs by the pooling of depreciating assets²⁵⁹ and to reduce the tax burden of small business.²⁶⁰ Whilst there will be reduced record keeping and simpler accounting for depreciating asset disposals for certain small businesses, there are a number of reasons why these benefits are limited.

First, the SBE accelerated depreciation rates mainly benefit a minority of small businesses that have high cost depreciating assets. Secondly, this benefit has been reduced by the re-introduction of accelerated depreciation into Div 40. This is particularly so for businesses having significant depreciating assets with effective lives of 6 2/3 years or less. The same applies for businesses having significant depreciating assets with effective lives of between 25-40 years. For such assets the accelerated depreciation rates are much higher under the Div 40 capital allowance rules as seen by the example shown in table 1.

Table 1: Comparison of Diminishing Value (DV) depreciation rates under Div 40 and Subdiv 328-D
(The higher of the Div 40 or the STS DV rates are outlined in bold)

Asset	Effective Life Years	STS / SBE DV rate	Div 40 DV rate Post-10 May 2006 assets
Iron tank stand	33.33	5%	6%
Fence	20	30%	10%
Truck	15	30%	13.33%
Log trailer	10	30%	22.5%
Tractor	6 2/3	30%	30%
Taxis	4	30%	50%

Thirdly, the inflexibility and complexity of the SBE depreciation regime would appear to offset the simplification gains. Fourthly, the widespread use of computer software packages to calculate depreciation under Div 40 would produce few difficulties in updating depreciation calculations. Fifthly, given that many small businesses are likely to own relatively few depreciating assets then any compliance savings from subdiv 328-D would be small. Finally, the SBE treatment is contrary to accounting practices where depreciable assets are required to be amortised over the period in which the income that is directly related to those assets is earned.²⁶¹ This means small business will have to prepare two sets of accounts, for taxation and financial accounting purposes.

²⁵⁹ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, paras 5.6 – 5.8.

²⁶⁰ *Ibid* para 1.7.

²⁶¹ Hoggett above n 33, 130; AASB *Framework* above n 28, para 94, 95.

D Trading Stock

Under the SBE trading stock regime taxpayers have a choice in adopting the simplified trading stock regime or utilising the normal trading stock rules in Div 70.²⁶² In the SBE regime, where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is less than \$5,000, SBE do not have to value each item of trading stock at year end and account for any changes in the value of trading stock.²⁶³ The opening value of trading stock is deemed to equal the closing value of trading stock.²⁶⁴ If the change in trading stock is greater than \$5,000 the normal trading stock rules apply.²⁶⁵ In 1999, the *Review* considered that 75 per cent of small business would be able to use this exemption and that the removal of the need to account for trading stock would simplify small business tax accounting.²⁶⁶

E Further Issues

The rationale for the special STS / SBE trading stock rule was one of simplification for small business.²⁶⁷ Avoiding a stock take under the SBE rules, though, can result in significant costs for small business as follows. First, there is the difficult problem of working out what constitutes a 'reasonable estimate' of trading stock in s 328-285(1)(b). Secondly, it appears that the general trading stock rules in Div 70 also apply to taxpayers electing to use the SBE trading stock rules, thus further complicating subdiv 328-E.²⁶⁸ Thirdly, most small businesses will nevertheless need to carry out a stock take for financial accounting and internal control purposes.²⁶⁹ Finally, the \$5,000 limit recommended in 1999 has not been indexed for inflation and given the low take up of the STS, many small businesses carrying trading stock would not appear to be affected by subdiv 328-E. As commentators noted in respect of the STS trading stock rules, the non tax benefits of stock takes exceeded the costs of undertaking stock takes.²⁷⁰

F Summary

The great number of small businesses eligible for the SBE concessions means that considerable resources are employed by small businesses in annually calculating their eligibility and the net benefits from the various concessions. Given the complexity of the SBE income tax accounting concessions, this is likely to be a very time intensive process and costly for taxpayers who prepare their own tax returns. Many of these taxpayers will simply choose to ignore the concessions given their complexity. Other

²⁶² s 328-285(2).

²⁶³ s 328-285(1).

²⁶⁴ s 328-295(1).

²⁶⁵ s 328-290.

²⁶⁶ *A Tax System Redesigned* above n 6, 586.

²⁶⁷ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 6.2.

²⁶⁸ In ATO Interpretive Decision ID 2003/90 the Commissioner asserted that an STS taxpayer could make an election under s 70-100(4) to treat their trading stock as disposed of at a closing value other than market value, provided the conditions in s 70-100 were satisfied.

²⁶⁹ *AASB Framework* above n 28, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

²⁷⁰ Hine above n 5, 3-38; Bondfield above n 5, 334; Kenny above n 5, 41-42; McKerchar above n 5, 144.

taxpayers who rely on tax practitioners will incur extra costs in accessing the concessions given their complexities.

The structural problems in the former STS of inflexibility, complexity and the poor targeting of small business, all re-appear in the SBE regime. The SBE rules are too complicated and provide too few benefits for small business.

IV CONCLUSION

The SBE regime attempts to fix some of the problems that arose from the former STS. The streamlining the definition of a small business for the various taxation concessions and the improved flexibility are steps in the right direction but other problems remain.

The SBE regime does not address the underlying structural problems in the STS. That is, the new rules fail to provide an appropriate universal definition of a 'small business'. The various small business taxation concessions still have a number of additional or alternative requirements that negate the benefit of the SBE definition. This breaches the *Review's* recommendation of an integrated tax code having a common dictionary.

Further, the removal of the \$3 million depreciating asset limit damages the integrity of the SBE definition of a small business since larger capital intensive businesses will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold. The increase in the turnover threshold will lead to further inequity as larger small businesses gain the most from the SBE regime. The question of what constitutes a small business still remains to be answered. The taxation laws need an appropriate and universal definition of small business.

The optional treatment of the three SBE income tax accounting concessions appears to provide some improvement to simplicity for small business. However, the SBE eligibility rules and the depreciation, prepayment and trading stock concessions share similar complex technical issues as the former STS provisions. Adjusting to the new rules also involved transitional costs.

Additionally, the SBE income tax accounting concessions are a blunt policy device as they continue to favour a minority of small businesses and only provide a timing benefit from the temporary deferral of income tax. Overall, these three SBE income tax accounting concessions do not appear to offset the compliance costs for the small business sector by reducing the effective tax burden for small business. Future publication by the Australian Taxation Office of the take up of the SBE income tax accounting concessions by small business will provide very important feedback to policy makers as to the success of these reforms.

THE APPLICATION OF STANDING IN REVIEWING TAXATION DECISIONS

RODNEY FISHER*

*A central aspect of the reform of administrative law in the 1970s was to provide increased administrative accountability by way of review of a range of administrative decisions and processes. However such review or appeal rights only subsist if a party has standing to seek such review or appeal. This paper examines the application of 'standing' to seek review of taxation decisions. The paper focuses in particular on the decision in *Allan v Transurban City Link* to highlight how a narrow approach to statutory interpretation in relation to the issue of standing may undermine the taxpayer's right of review.*

I INTRODUCTION

The mid-1970s was a watershed period for administrative law reform, with the codification of many of the common law actions, the intended outcome being a more transparent and more accountable government administration. A central aspect of this increased accountability provided for review of a range of administrative decisions and processes, in particular by means of the Administrative Appeals Tribunal¹ (AAT), and by way of judicial review.²

In broad terms, an application for review could be made to the AAT by a "person whose interests are affected"³ by the decision, while an application for judicial review of a decision becomes available to a "person aggrieved by a decision."⁴ There has been some judicial consideration as to the breadth of persons encompassed within these terms, with the paper outlining the outcomes from this judicial deliberation. The paper then explores the scope of the circumstances which allow for review or appeal of administrative decisions, in particular decisions relating to tax liability.

In examining the issue of limitation of the right to seek review, the discussion focuses on the High Court decision of *Allan v Transurban City Link Limited*.⁵ The discussion seeks to highlight the possibility of the legislature being able to subvert the underpinning rationale for the administrative remedies, albeit with the assistance of favourable court decisions.

II THE ISSUE OF STANDING

There have been a number of cases where the courts have considered the question of standing, with this review of judicial considerations highlighting some of the significant decisions which underlie the general principles applying to standing. In addition to these general principles, there are further legislative requirements for

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¹ Created by the *Administrative Appeals Tribunal Act 1975* [AAT Act].

² By means of the *Administrative Decisions (Judicial Review) Act 1977* [(AD(JR) Act].

³ AAT Act s 27(1).

⁴ AD(JR) Act s 5(1).

⁵ (2001) 48 ATR 253.

standing in the tax context, and these are examined in the following section of the paper.

In the decision in *Boyce v Paddington Borough Council*,⁶ Buckley J identified two circumstances where a plaintiff had a right to sue without joining the Attorney-General:

... first, where the interference with the public right is such as that some private right of his is at the same time interfered with ... and secondly, where no private right is interfered with, but the plaintiff, in respect of his public right, suffers special damage peculiar to himself from the interference with the public right.⁷

Subsequent cases have sought to ameliorate the complexity associated with application of these rules, with standing seen as not requiring special damage in the traditional sense, but requiring a plaintiff "... having a special interest in the subject matter of the action."⁸ However the application of such a principle would depend on the circumstance, since "The cases are infinitely various and so much depends in a given case on the nature of the relief which is sought, for what is a sufficient interest in one case may be less than sufficient in another."⁹

A further question for consideration has arisen from recognition that interests may be affected directly or indirectly, since "... a decision which affects interests of one person directly may affect the interests of others indirectly. Across the pool of sundry interest, the ripples of affection may widely extend."¹⁰ In determining whether the strength of indirect interests is sufficient:

The character of the decision is relevant, for if the interests relied on are of such a kind that a decision of the given character could not affect them directly, there must be some evidence to show that the interests are in truth affected.¹¹

This issue of the relative strengths of indirect interests was addressed in *Australian Foreman Stevedores Association v Crone*,¹² with Pincus J recognising that:

A decision favourable to one citizen may affect others: some directly, and some more remotely. There is a point, which must be fixed as a matter of judgement in each case, beyond which the Court must hold that the interests of those affected are too indirectly affected to be recognised.¹³

Where a statute provides recourse to review for a 'person aggrieved' or a 'person whose interests are affected,' statutory interpretation has a role to play, the court in *Alphafarm Pty Ltd v Smithkline Beecham (Australia) Pty Limited*¹⁴ suggesting that:

... it is important not to draw ... any general proposition which may be translated to the instant dispute. In each case, the content of the terms 'affect' and 'interest' are to be seen in the light of the scope and purpose of the particular statute in issue.¹⁵

This approach was again affirmed by Gummow J in *Australian Institute for Marine and Power Engineers v Secretary Department of Transport*,¹⁶ whereby "... given the diversity of statutory provisions, no general proposition is to be established from these

⁶ [1903] 1 Ch 109.

⁷ *Ibid* at 114.

⁸ *Went worth v Attorney-General (NSW)* (1984) 154 CLR 518, per Gibbs CJ at 527.

⁹ *Robinson v Western Australian Museum* (1977) 138 CLR 383 per Mason J at 327-8.

¹⁰ *Re McHattan and Collector of Customs* (1977) 18 ALR 154 per Brennan J at 157.

¹¹ *Ibid*.

¹² (1989) 20 FCR 377.

¹³ *Ibid* at 382.

¹⁴ (1994) 49 FCR 250.

¹⁵ *Ibid* per Gummow J at 272.

¹⁶ (1986) 13 FCR 124.

examples.”¹⁷ Further, “... the nature of the interest required in a particular case will be influenced by the subject matter and context of the decision under review.”¹⁸

III STANDING IN TAX ADMINISTRATION

One of the factors creating difficulties in judicial review of the question of standing in taxation matters has been the different terminology in different legislation setting the threshold requirement for standing.

The initiation of proceedings for review or appeal of an income tax assessment is provided in s 175A Income Tax Assessment Act 1936, which creates the right to object against an assessment for “a taxpayer who is dissatisfied with an assessment made in relation to the taxpayer”. A literal reading of the provisions would suggest three threshold requirements to create the right to object, these being:

- a taxpayer
- dissatisfied with an assessment
- where the assessment is made ‘in relation to’ the taxpayer.

Section 175A directs dissatisfied taxpayers to Part IVC of the Tax Administration Act for objection procedures, and the subsequent review and appeal procedures if there is an unfavourable objection decision. Part IVC of the Tax Administration Act provides a uniform code of procedures which apply for objections, reviews and appeals under all Commonwealth tax statutes, thus applying to income tax, fringe benefits tax, goods and services tax, and the superannuation guarantee charge. The application of a uniform code means that the threshold issue of standing will be the same for taxpayers seeking review under any of these taxing provisions.

The requirements for further review or appeal are stated in s 14ZZ Tax Administration Act, with the right for review or appeal being available for “the person dissatisfied with the Commissioner’s objection decision ...”.

In the majority decision in *McCallum v FCT*¹⁹, Lehane J concluded that:

There can, I think, be no doubt that ‘the person’ referred to in s 14ZZ ... is the same person as the one referred to in s 14ZU itself ... and subs 14ZL(1) makes it clear that ‘the person’ concerned is the taxpayer referred to in s 175A ... who is dissatisfied with an assessment ‘made in relation to the taxpayer’.²⁰

In a case involving a taxpayer seeking review of a private ruling, Hill J found in *CTC Resources v FCT*²¹ that:

There is no definition of ‘dissatisfied’ in this context but the word must bear more than its ordinary dictionary meaning of ‘displeased with’ or ‘not contented with’. More is required than mere lack of satisfaction with the objection decision. ... In my opinion a person will only be ‘dissatisfied’ in the relevant sense if that person is a person to whom the ‘ruling’ is still capable of having legal effect. ... so that the ruling can not affect the taxation liability of a putative appellant, that person, no matter how discontented, will not be a ‘person dissatisfied.’²²

At issue in *McCallum v FCT* was whether a bankrupt taxpayer had standing to appeal or seek review. Hill J, in a minority decision, noted the range of terminology

¹⁷ Ibid at 131.

¹⁸ *United States Tobacco Company Minister for Consumer Affairs* (1988) 20 FCR 520 at 529.

¹⁹ 97 ATC 4509.

²⁰ Ibid at 4521.

²¹ 94 ATC 4072.

²² Ibid at 4100.

relating to standing, including the expressions ‘person dissatisfied’, ‘person interested’, ‘person affected’, and ‘person aggrieved’. His Honour concluded that the divergent expressions may be seen to indicate shades of difference, such that it would “... not be wholly safe to extrapolate from decisions on the one set of words the outcome where dependent upon another set of words.”²³

The majority decision²⁴ in *McCallum* held that while a bankrupt taxpayer did not satisfy the requirement for review or appeal in their own name, the trustee in bankruptcy did have standing. The decision was based on the High Court decision in *Cummins v Claremont Petroleum*²⁵, with Whitlam J following the view in *Cummins* that it is fundamental to the law of bankruptcy that the bankrupt is divested of liability for his provable debts, and as the taxation debt is a provable debt of which the bankrupt is divested, “... he will not be the person to whom ‘the objection decision’ is still capable of having legal effect”²⁶.

In a strong dissenting view, Hill J noted that Ellicott J in *Tooheys v Minister for Business and Consumer Affairs*²⁷ suggested that “The words ‘a person who is aggrieved’ should not, in my view, be given a narrow construction.”²⁸ Hill J was inclined to the view that ‘dissatisfaction’ provided a broader gateway than ‘aggrieved’, warning that if the criteria for review were set narrowly, the objects of administrative review could be frustrated.²⁹ His Honour was of the view that, while dissatisfaction required more than a mere intellectual or emotional interest,³⁰ there should be no requirement to demonstrate that a legal right was affected to make out ‘dissatisfaction’.³¹

Lehane J argued against this broader interpretation, suggesting that it was not easy to see that a test of dissatisfaction with a decision should confer standing on a taxpayer to a more generous extent than a right of appeal does for a party adversely affected by a decision.³² His Honour noted that a taxpayer who lacked standing, as with a bankrupt, wanted to challenge an assessment, the Court could exercise its power to prevent injustice or oppression.³³

The warning by Hill J as to the dangers of a narrow interpretation of expression granting standing, and the potential for a narrow approach to defeat the objects of administrative review, may have been prophetic, given the long running legal battle which ultimately ended in the High Court as *Allan v Transurban*.³⁴ The progress of this case is charted below, with a review of the question of standing at each stage of the proceedings.

IV ALLAN V TRANSURBAN CITY LINK

The case involving Peter Allan’s quest to be recognised as having standing as a ‘person affected’ followed a long, and ultimately futile, path. After commencing in

²³ *McCallum v FCT* 97 ATC 4509 at 4515.

²⁴ Lehane & Whitlam JJ.

²⁵ (1995) 185 CLR 124.

²⁶ *McCallum v FCT* 97 ATC 4509 at 4518.

²⁷ (1981) 36 ALR 64.

²⁸ *Ibid* at 79.

²⁹ *McCallum v FCT* 97 ATC 4509 at 4516.

³⁰ See for example *ACF v Commonwealth* (1980) 146 CLR 493.

³¹ *McCallum v FCT* 97 ATC 4509 at 4516.

³² *Ibid* at 4522.

³³ *Ibid* at 4523.

³⁴ *Allan v Transurban City Link Ltd* [2001] HCA 58; (2001) 48 ATR 253.

the AAT in the mid 1990s, the case progressed through the Federal Court to the Full Federal Court, from whence it was remitted to the AAT, and again progressed through the Federal Court and Full Federal Court, until eventually reaching the High Court.

The decision against which Allan sought review was a decision of the Development Allowance Authority (DAA), a body created under the *Development Allowance Authority Act* (DAA Act) for the purpose of issuing certificates which granted tax concessions where privately funded large public infrastructure projects met certain criteria. Under s 93O of the DAA Act, where the DAA was satisfied that the conditions had been met there was no discretion to refuse a certificate.

Additionally, the applicant for a certificate was the only party with a right to be heard by the DAA, the only party from which the DAA could seek information and documents, and the only party to which notice of the decision had to be given, there being no requirement for public notification of receipt of an application or a decision on the application.

The provision of the DAA Act at issue was s 119, which provided in relevant part:

(1) A person who is affected by a reviewable decision may, if dissatisfied with the decision, by notice given to the DAA ...

...

request the DAA to reconsider the decision.

...

(3) Upon receipt of the request, the DAA must reconsider the decision”

Section 120 of the DAA Act provided that:

“Applications may be made to the AAT for review of decisions of the DAA that have been confirmed or varied”

The DAA decision for which Allan sought review involved the issuing of a certificate for construction of a freeway to within one hundred metres of his home. Allan requested the DAA to reconsider its decision, under s 199 of the DAA Act, the response from the DAA being to decline to reconsider on the basis that Allan was not a ‘person who is affected by the decision.’

A First Round of Hearings

1 AAT

On the basis that the failure by the DAA to reconsider its decision amounted to a confirmation of the decision, Allan applied to the AAT for a review of the DAA decision.

At first instance in the AAT, the Tribunal considered that the degree of adverse affection was too remote for Allan to be classed as a ‘person whose interests are affected’, and as he was not therefore a ‘person affected by a reviewable decision’, the AAT had no jurisdiction to hear the matter.

Undeterred by this setback, Allan took the case to the Federal Court,³⁵ where it was first heard by Mansfield J.

³⁵ *Peter Allan v Development Allowance Authority* [1997] 738 FCA.

2 Federal Court

From a consideration of the authorities, Mansfield J concluded that ultimately the question turned on what Parliament intended by the expression ‘a person who is affected by ...’ the decision in s 119 of the DAA Act. While assuming that Allan was a person who had suffered ‘special damage’ within the terms of *Boyce*, His Honour concluded that Allan was not encompassed as a ‘person affected’ within the meaning of the Act, and as such the DAA and AAT were correct in their assertion. The meaning ascribed to the Act in the following broad areas led to this conclusion.

Firstly, only the applicant for a certificate had input to the decision process. On this basis His Honour considered that:

... it is not likely that the parliament contemplated by s 119 that a person who had chosen not to participate in these primary determinative processes ... should by reason of special interests of the nature claimed have another opportunity to achieve indirectly what the person had not achieved directly.³⁶

Further, as only the applicant for the certificate was entitled to notification of the DAA decision, with no requirement for public notification, the intention of the legislature was that the decision process be private.

Additionally, as the Act provided a period for review of twenty-one days after the decision came to the person’s attention, His Honour felt that the intention was to limit review to the applicant. To adopt a different interpretation would leave open-ended the period for review, which would not have been the intention of Parliament.

Finally, His Honour considered that the decision under complaint was not the decision directly causing the special damage of which Allan complained, as the decision at issue had an outcome of the project attracting finance and tax concessions.

For these reasons Mansfield J concluded that s 119 of the DAA Act should have a narrow interpretation, with “a person who is affected” being limited basically to the original applicant for a DAA certificate. His Honour found this conclusion to be apparent both from the legislative provision, and from general principles enunciated by the High Court.

3 Full Federal Court

On appeal to the Full Federal Court, the decision of Mansfield J was overturned by all members of the Court.³⁷ The decisions of Wilcox and R D Nicholson JJ are examined below, Finn J being substantially in agreement with them.

In the view of Wilcox J, the fundamental defect in the argument of the respondent was failing to draw the distinction between the criteria relevant to the statutory decision, and the subject matter of the litigation challenging the decision. His Honour found that, using ordinary language, a person whose residential amenity would likely be diminished is a person affected by the decision, which raised a question of degree, as a special interest is required to confer standing. Where His Honour differed from Mansfield J was that he did not agree with the further requirement that the special interest be related to the objects, scope or purpose of the legislation under which the decision had been made.

In reviewing the authorities, His Honour considered that *Boyce* was the seminal decision in the area, and the second leg of the standing rule proposed by Buckley J

³⁶ Mansfield J at 12 of 14.

³⁷ *Allan v Development Authority* [1998] 112 FCA; Wilcox, R D Nicholson, and Finn JJ.

had been reformulated by Gibbs J in *ACF* to refer to a person “having a special interest in the subject matter of the action.”³⁸ In explanation of this special interest, Gibbs J noted that “... an interest for present purposes, does not mean a mere intellectual or emotional concern.”³⁹ Rather, a special interest required the plaintiff gaining some advantage other than general satisfaction if the action succeeded, or suffering some disadvantage if it did not.

The majority of the Court in *Onus v Alcoa*⁴⁰ adopted this concept of ‘special interest’, with Gibbs CJ expounding on the meaning as “... an interest in the subject matter of the present action which is greater than that of other members of the public.”⁴¹ In explanation of the concept, Stephen J saw it involving “... a curial assessment of the importance of the concern which a plaintiff has with particular subject matter and of the closeness of that plaintiff’s relationship to that subject matter.”⁴²

Further, in *Shop Distributive and Allied Employees Association v Minister for Industrial Affairs South Australia*,⁴³ (SDAEA), the Full High Court suggested that the “... rule is flexible and the nature and subject matter of the litigation will dictate what amounts to a special interest.”⁴⁴

The point made by Wilcox J was that in none of these cases was it suggested that the nature of the special interest was to be determined by reference to the scope and purpose of the legislation. Additionally:

In none of the High Court cases is there any suggestion that the concern that amounts to a special interest must be the same concern as that which motivated the legislature in enacting the legislation out of which the action arose ... it was enough that members of the appellant organization had an interest in the validity of the certificates that transcended that of the public generally.⁴⁵

On the basis of these authorities, Wilcox J was able to determine that Mansfield J had erred in finding a legislative intent that a ‘person who is affected’ in terms of s 119(1) was limited to the applicant for a certificate. Wilcox J further noted that Mansfield J had assumed that Allan had suffered special damage, which in the view of Wilcox J would make Allan a ‘person who is affected.’

The order proposed by His Honour was to allow the appeal, but remit the matter to the AAT for the making of a finding as to the position of Allan.

R D Nicholson J concurred with the orders made by Wilcox J. His Honour found that the test for standing from *Shop Distributive and Allied Employees Association* was whether the plaintiffs could establish the existence of a special interest in the subject matter of the litigation,⁴⁶ and that it was apparent from the authorities that the “... concept of special interest is wider than the concept of special damage.”⁴⁷

His Honour relied on the finding in *Onus* that:

Whether a plaintiff has shown a sufficient interest in a particular case must be a question of degree, but not a question of discretion ... At least the plaintiff must be able to show that success in the action would confer on him ... a benefit or advantage greater than the benefit or

³⁸ Ibid at 3 of 16 referring to *ACF v Commonwealth* (1980) 146 CLR 493 per Gibbs J at 527.

³⁹ *ACF v Commonwealth* (1980) 146 CLR 493 per Gibbs J at 530.

⁴⁰ (1981) 149 CLR 27.

⁴¹ Ibid per Gibbs CJ at 36.

⁴² Ibid per Stephen J at 42.

⁴³ (1995) 183 CLR 552.

⁴⁴ Ibid at 558.

⁴⁵ *Allan v Development Authority* [1998] 112 FCA at 4 of 16.

⁴⁶ *SDAEA v Minister for Industrial Affairs South Australia* (1995) 183 CLR 552 at 558.

⁴⁷ *Allan v Development Authority* [1998] 112 FCA per Nicholson J at 12-13.

advantage conferred upon the ordinary member of the community; or alternatively that success in the action would relieve him of a detriment or disadvantage ... to an extent greater than the ordinary member of the community.⁴⁸

This test was considered to be met in the instant case, since “The special damage lies within the point in the pool of sundry interest at which the affection is not remote.”⁴⁹

Further, His Honour found no basis for the limitation by inference drawn from the legislation by Mansfield J, by which the provision operated to limit the class of applicants who could seek review.

B Second Round of Hearings

The case, then, returned to the place from whence it had started its journey, coming again before the AAT for the determination of whether Allan was a person affected within the terms of s 119(1) of the DAA.

1 AAT

Further complexity arose at the AAT hearing when the issue of Allan having moved his residence was raised. This then broached the additional question as to the temporal nature of standing, and whether Allan was no longer a person affected by the DAA decision, the issue being whether standing was required only at the time the person was affected by the decision, or whether the requirement is ongoing.

In essence, the AAT concluded that to have standing, Allan needed to demonstrate that at the time of this further hearing he retained a special interest in the subject matter of the DAA decision. By virtue of having moved residence, the AAT was not satisfied that Allan met the requirement for such an interest, and affirmed the decision under review, being the initial AAT decision that Allan was not a person affected by the DAA decision.

Interestingly, the AAT affirmed the previous decision, although it did so by the consideration of different facts, which arguably was not what the referral from the Full Federal Court had asked of it.

2 Federal Court

Allan again appealed against the decision of the AAT, with the matter again returning to the Federal Court,⁵⁰ this time before Merkel J.

In looking to the AAT Act, His Honour determined that ss 27 and 29 required only that standing exist at the date on which application for review is made to the AAT, there being nothing to indicate that the requirement for standing was ongoing. Additionally His Honour saw the “... concept of standing being ‘lost’ or ‘gained’ according to the circumstances existing from time to time (as) an unsatisfactory basis for determining a person’s right to commence and continue a proceeding ...”⁵¹

While the AAT had based its decision on the ACF test enunciated by Gibbs J, Merkel J considered that this framed the question in narrow terms, importing a test that would not be “... accepted as necessarily applicable to all cases of standing to

⁴⁸ *Onus v Alcoa* (1981) 149 CLR 27 per Brennan J at 75.

⁴⁹ *Allan v Development Authority* [1998] 112 FCA per Nicholson at 15.

⁵⁰ *Allan v Development Allowance Authority* [1999] FCA 426.

⁵¹ *Ibid* at para 39.

seek administrative review.”⁵² Rather, His Honour concluded that more recent cases evidenced a more flexible test based on a special interest greater than, or different in kind from, ordinary members of the community,⁵³ with s 27 of the AAT Act being flexible in its application.

By confining its enquiry into whether Allan had actually proved special damage, Merkel J found that the AAT had erred in law by approaching the issue of special damage or sufficiency of interest too narrowly. His Honour considered that Allan’s standing arose from an accrued right to reconsideration of the DAA decision, with that standing not being affected by the change in residence.⁵⁴

As a result, the decision in the case held that the AAT had erred in law by failing to consider whether Allan was a person affected by the DAA decision, being the matter which had been referred for determination to it by the Full Federal Court. Merkel J again remitted the matter to the AAT for determination of this issue.

3 Full Federal Court

By this stage of the proceedings it came as no great surprise when, instead of returning to the AAT, the matter progressed on appeal yet again to the Full Federal Court,⁵⁵ on this occasion sitting as a five-member bench.⁵⁶

(a) Reconsideration by Full Federal Court

Before consideration of the substantive matter at issue, the Court deliberated on the question of whether the Court should reconsider a previous Full Court decision. While the Court was of the view that “It is not in doubt that a Full Court of this Court has power to decline to follow the previous decision of a differently constituted Full Court,”⁵⁷ it was felt that “Decisions of a Full Court of this Court are entitled to due respect and will not be lightly departed from.”⁵⁸ In reaching this conclusion, regard was had to the judgement in *Nguyen v Nguyen*⁵⁹ where it was observed that “Where a court of appeal holds itself free to depart from an earlier decision it should do so cautiously and only when compelled to the conclusion that the earlier decision is wrong.”⁶⁰

From a review of the authorities the Court determined that “... we do not think it possible, or even desirable, to formulate exhaustive criteria upon which this Court should act when asked to reconsider an earlier decision,”⁶¹ with the arguments and circumstances being among the determining factors. The Court found some unusual features in the circumstances in the case, not least that Transurban had not been a party to the previous case yet had a serious interest, and that the previous Full Court would have been assisted by the arguments advanced by Transurban.

⁵² Ibid at para 55.

⁵³ Ibid at para 56.

⁵⁴ Ibid at para 68.

⁵⁵ *Transurban City Link Ltd v Allan* [1999] FCA 1723.

⁵⁶ Black CJ, Hill, Sundberg, Marshall and Kenny JJ.

⁵⁷ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 27.

⁵⁸ Ibid.

⁵⁹ *Nguyen v Nguyen* (1990) 169 CLR 245.

⁶⁰ Ibid per Dawson, Toohey & McHugh JJ at 268-269.

⁶¹ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 31.

On this basis the Court took the view that the "... circumstances provide sufficient reason for the Court to embark upon a consideration of whether the previous decision was wrongly decided."⁶²

(b) The question of standing

Having satisfied itself that it was not inappropriate for the Court to reconsider a previous Full Court decision, the Court turned to address the issue of standing.

The Court looked to the decision in *Bateman's Bay Local Aboriginal Land Council v Aboriginal Community Benefit Fund Ltd*,⁶³ a decision subsequent to the previous Full Court decision in the current case, and noted that the leading judgement⁶⁴ pointed out that it was significant in matters of standing to have regard to the considerations upon which equity intervenes in public law cases, the basis for such intervention being found in the public interest in the maintenance of due administration.⁶⁵ It was noted that this judgement approved of the finding in *Shop Distributive and Allied Employees Association* where it had been noted that the danger of adopting a precise formula for determining what was sufficient for a special interest could have the effect of unduly restricting the availability of equitable remedies to support the public interest in due administration.⁶⁶

Also from the *Aboriginal Community Benefit Fund*, McHugh J had noted that a special interest in the subject matter of the proceedings sufficed to give standing.⁶⁷ This suggested that for the Court to disturb the previous Full Court decision would require a finding that Allan had no special interest in the subject matter, where four previous judges had found there was such an interest.

The Court relied on the test for standing from ACF, requiring a special interest greater than others in the community. In looking to the factors of relevance in this consideration, the Court drew on the decision in *North Coast Environment Council Ltd v Minister for Natural Resources*,⁶⁸ where the view of Aickin J was that to qualify as special interest, the interest must be related to the relief claimed. Following this view, the Court considered that if granting relief did not further the interests of the plaintiff, or failure to grant relief did not cause harm, then "... common sense would suggest that the applicant for judicial review would lack standing."⁶⁹

While the Court could find no support for this view in later High Court cases, with *Onus* suggesting the relationship should be between the applicant and the subject matter of the proceedings rather than between the applicant and the outcome of the proceedings, neither could the Court find anything to suggest consideration of the outcome would be irrelevant. On this basis the Court was able to conclude that "... there will be no standing where the actual outcome of the review will not affect the applicant."⁷⁰

In applying these considerations to the current case, the Court took the view that the subject matter of the review was the decision to issue certificates which affected the

⁶² Ibid.

⁶³ (1998) 194 CLR 247.

⁶⁴ Gaudron, Gummow and Kirby JJ.

⁶⁵ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 38.

⁶⁶ Ibid.

⁶⁷ Ibid at para 39.

⁶⁸ (1994) 55 FCR 492.

⁶⁹ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 46.

⁷⁰ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 50.

tax treatment of the infrastructure borrowings, so for Allan to establish standing for review of that decision it was necessary for him to demonstrate an interest in the decision as to the tax treatment for a borrower or lender. Further, in terms of the outcomes, it was relevant to consider whether at the time of application, the interest he claimed would be advanced or harmed by the outcome of the review.

By taking this narrow approach, the Court was able to determine that Allan had no greater interest in the tax treatment of the loans than any other member of the community, and while he did have an interest in whether the infrastructure project should proceed, that interest was too remote from the decision for which he sought review.⁷¹

In highlighting the significance to be attached to the outcome from the review in determining standing, the Court did allow that the object, scope and purpose of the legislation was relevant, but denied that it could be the only relevant matter.⁷²

Nevertheless, largely on the basis that he had no special interest in the outcome of the decision, narrowly construed, the Court reversed the previous decision of the Full Federal Court and found that Allan was not a person affected by the decision, and accordingly lacked standing.⁷³

(c) Approach of Full Federal Court

The finding of the Court is an interesting decision in a number of areas, with some of these briefly examined before returning to the continuing Allan saga, which was nearing its conclusion.

The Court paid regard to the decision in *Aboriginal Community Benefit Trust*, particularly to the view of Gaudron, Gummow and Kirby JJ that in determining standing, regard should be had to considerations upon which equity intervenes in public law, the basis for intervention being the public interest in the maintenance of due administration. The considerations of public interest suggest a broad interpretation being given to the special interest required for standing, with the impression being created that the Court would have regard to this broad public interest view in deciding the instant case.

However, while noting the comments from *Shop Distributive and Allied Employees Association* as to the danger of adopting a precise formula as to the requirements for special interest, the danger being to constrict the remedies available, the Court then appears to overlook the High Court cases as to the requisite relationship to establish special interest and standing, and draws instead on a Federal Court decision.

Further, the comments relied on from the decision in *North Coast* may arguably appear at odds with the High Court authority, the decision suggesting that it is the outcome from the proceedings, rather than the subject matter of the proceedings, which is determinative. By setting this as the criteria, the decision of the Court may be at odds with the warning from *Shop Distributive and Allied Employees Association* as to adopting too precise a formulation as to the sufficiency for special interest and standing.

Finally, in applying the 'outcome' test, the Court arguably takes a quite narrow interpretation of the decision in question. While the decision as to the issue of a certificate by the DAA does determine the tax treatment for the infrastructure loan,

⁷¹ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 52-54.

⁷² *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 55.

⁷³ *Transurban City Link Ltd v Allan* [1999] FCA 1723 at para 57.

this in turn then directly impinges on the undertaking of the project subject to the financial agreement. By drawing a line at the tax treatment as being the only outcome from the decision to issue a certificate, the Court has taken a narrow literal approach arguably at odds with the public interest approach commended in *Shop Distributive and Allied Employees Association*.

The Court recognised that Allan had an interest in whether the project proceeded, and by segmenting this decision from the decision as to tax treatment for the funding arguably creates an artificial divide where none existed, as the issuing of a certificate led inexorably to the conferral of tax advantages and the commencement of the project. The creation of segmentation between the two resultant outcomes which arguably follow together may be seen as adopting an approach which is both narrow and legalistic.

However the Court found that it was able to make such a fine distinction.

4 High Court

As an example of "... the fortitude required by a citizen who wishes to draw upon administrative law procedures for enforcement of modern public statutory duties against public authorities and large corporations,"⁷⁴ there is no better example than this case, with such fortitude amply illustrated with an ultimate appeal to the High Court.⁷⁵

However the fortitude was not to be rewarded, with a 5:1 majority of the High Court finding against Allan.

(a) Majority judgement

In the joint judgement of the majority,⁷⁶ there were two questions which would determine the appeal. The first was whether s 119 of the DAA Act, providing for review of a DAA decision, had any application in respect of a decision by the DAA to issue a certificate, or whether it only applied where issue of a certificate had been refused. Following from this, if the section allowing review was equally relevant to all decisions, the question arose as to whether Allan was a person 'affected by' the decision to issue a certificate.

From its consideration of the first of these questions, it may appear that the majority avoided the issue of standing. Section 119 of the DAA Act provided for a person affected by a reviewable decision to request reconsideration of the decision. The majority judgement effectively concluded that a decision by the DAA to issue a certificate was not a reviewable decision, and as such the question of standing for Allan did not arise. It would seem that the majority judgement considered that only a decision to refuse a certificate could amount to a reviewable decision, and as a certificate had been issued in this instance, there was no reviewable decision and no basis for reconsideration. This is what the majority appear to suggest in finding that "What is fatal to Mr Allan's case is that he sought involvement in a decision to issue a certificate."⁷⁷

However, while having determined there was no reviewable decision, thus ending the matter, the majority did go on to consider the question of standing. The phrase in s

⁷⁴ *Allan v Development Allowance Authority* [1999] FCA 426 at para 1 per Merkel J.

⁷⁵ *Allan v Transurban City Link Ltd* [2001] HCA 58; (2001) 48 ATR 253.

⁷⁶ Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ.

⁷⁷ *Allan v Transurban City Link Ltd* [2001] HCA 58 at para 38.

119 referring to a person ‘who is affected by a reviewable decision’ was seen to have an ambulatory operation, and “What serves to identify a person as one affected by a reviewable decision will vary having regard to the nature of the reviewable decision itself.”⁷⁸ In looking to identify persons who would be affected in terms of the current legislative framework, the majority concluded that Allan could not come within this category.

The judgement noted that there was no provision in the legislative regime for giving notice to the public, or anyone other than the applicant for a certificate, and this was seen to demonstrate that “The legislation is not concerned with broader public interests such as those relating to the environmental, engineering, social or other aspects of the proposed infrastructure project.”⁷⁹

Further, if members of the public could seek reconsideration of a decision up to 21 days after becoming aware of the decision, this left open the potential for reconsideration at a delayed time, even to the extent of being after completion of the project.⁸⁰ Additionally, as the applicant for the certificate was the borrower, the majority considered that it would be an odd result if s 119 allowed Allan to seek reconsideration in circumstances where the lender, a party immediately affected by the decision, had not been a party to the original application.⁸¹

With the majority rejecting the appeal, at no stage had the matter been considered on the merits, even after two Tribunal hearings and five court cases.

(b) Dissenting view

Kirby J delivered a strong dissenting judgement broadly centred around the shortcomings which he perceived in the application of statutory construction, being critical of a narrow approach to statutory interpretation, particularly where this approach limited review of administrative decision making. His Honour considered that where, as in the current case, interpretation of federal legislation was required, ambiguity arose, with “Neither interpretation propounded (being) incontestably correct or incorrect.”⁸² Rather, the court needed to choose the preferable construction, being in his view “... the one that strikes the decision-maker as best achieving the object of the legislation, as derived from the language in which it is expressed.”⁸³

His Honour noted that the approach to resolving the ambiguity in legislative provisions can influence the outcome, with an approach focusing on certain words and phrases resulting in the appeal being dismissed, whereas a broader interpretation of the words within their context may produce an opposite result. In considering these alternatives, Kirby J considered that “... it is undesirable that a class of persons who may enlist the remedial provisions of such legislation should be unnecessarily narrowed ...”⁸⁴

In looking to the right of Allan to request the DAA to reconsider its decision, and the AAT to review the decision of the DAA, His Honour considered that it was not correct to use as a starting point the decision in *Boyce*, and the previous High Court

⁷⁸ Ibid at para 17.

⁷⁹ Ibid at para 34.

⁸⁰ Ibid.

⁸¹ Ibid at para 36.

⁸² Ibid at para 40.

⁸³ Ibid.

⁸⁴ Ibid at para 41.

decisions concerning the general law of standing. Rather, he saw the starting point as a close analysis of the legislation.⁸⁵

In contradistinction to the approach taken by other judges involved in this case, Kirby J took the view that:

There is a contemporary tendency ... to avoid or postpone such statutory analysis out of a preference for the general observations of judges concerning identical or analogous legislative provisions or principles of the common law. In a case such as the present the correct answer is likely to be masked by such an approach.⁸⁶

His Honour referred to reviews of the law of standing conducted by the Australian Law Reform Commission, and while conceding that much contemporary federal legislation reflected the common law principle requiring interference with a private right, or special damage, many federal statutes adopted a different formula. This led to the view that “The tendency of federal legislation is to move away from authorising only particular persons ... or persons limited by a controlling adjective (aggrieved, interested), to ‘any person’ ...”.⁸⁷ Accordingly, the “... solution to the problem in a particular case must always take as its starting point the language and structure of the legislative prescription in question.”⁸⁸

In regard to the instant case, His Honour identified two main controlling devices, the first being in s 119 DAA Act that the person seeking reconsideration be one ‘who is affected’, and the second being that the person making application to the AAT being one ‘whose interests are affected’. The question for determination was seen as whether these requirements had been met at the relevant time, being when the request was made to the DAA for reconsideration, and when the application was made to the AAT.

His Honour argued for a broad interpretation of the legislation, the trend of federal legislation being to “... enlarge the scope of rights to initiate administrative review,”⁸⁹ and applying a narrow interpretation ran the risk of turning back the clock, and departing from the legislative intent of widening “... the circle of persons who could exercise privileges under the applicable administrative law.”⁹⁰

In arguing for this broad application of the legislation, which His Honour considered in this case would grant Allan standing, the point was made that the broad language in ss 119 and 120 of the DAA Act demonstrated the Parliamentary intention to permit access to the review process. If such had not been the intent of Parliament, then Parliament had it within its power to have omitted the review provisions, or to have confined them within a narrow reach.

Urging a public policy perspective, Kirby J saw the systems of review in the DAA Act and AAT Act as providing greater transparency in public administration in the federal sphere. In relation to the outcomes from the DAA decision, the view expressed suggested that inconvenience or disruption to the tax position of others, or to the project itself, could ultimately outweigh the duty of officers and entities of the Commonwealth to comply with the law.

Despite the plea by Kirby J against narrow legislative construction, the majority found that Allan lacked standing, and the appeal against the decision of the second Full Federal Court was dismissed.

⁸⁵ Ibid at para 53-54.

⁸⁶ Ibid at para 54.

⁸⁷ Ibid at para 56.

⁸⁸ Ibid at para 56.

⁸⁹ Ibid at para 65.

⁹⁰ Ibid at para 65.

V JUDICIAL REASONING

While of the five court decisions, three proved unfavourable to the applicant Allan in that he was denied standing, the courts in each of the decisions differed in their reasoning as to how this result was achieved. Each of the courts looked to statutory construction to assist in determining the issue, and while the outcome in each case may have been the same, it is instructive to review the alternative interpretations of the statute which led to a common result.

In the Federal Court at first instance, the conclusion of Mansfield J was that if Allan was a 'person affected' within the meaning of s 199 of the DAA Act, this being "... apparent whether one looks only to the legislation for the answer to the question, or whether one looks to the more general principles enunciated by the High Court ...".⁹¹ His honour had regard to both of the nominated sources in reaching the conclusion.

In interpreting the relevant legislation, his Honour adopted the narrow interpretation that the review provided by the legislation was intended by Parliament basically only for those who were involved as applicants for a DAA decision, or required to be informed of the outcome of a decision, and that as Allan was not part of this loop, he had no standing to seek review.

From the principles from the High Court cases, an approach against which Kirby J warned, Mansfield J concluded that Allan needed to show special damage, and that this had not been done in this case.

The second Full Federal Court adopted a potentially narrower view of the scope of the legislation. The decision of the Court found that the question of standing would be determined by the interest Allan had in the decision under review, and that the subject matter of review was the decision to issue a certificate, the effect of which was to transfer tax benefits. As Allan had no interest greater than others in the community as to the tax benefits granted, he lacked sufficient interest in the decision.

By adopting this limiting view of the decision, the Court arguably narrowed the scope further, as it appeared to limit the outcome of the decision to immediate outcomes.

On reaching the High Court, it may appear arguable that the Court again narrowed further the interpretation of legislation granting rights of review.

The majority were able to determine the matter without having to decide on Allan's standing, effectively determining that there was no reviewable decision in terms of s 119 of the DAA Act. In a narrow reading of the legislation, the majority judgement concluded that the legislation intended that only a refusal to issue a certificate would be a reviewable decision, with a decision to issue a certificate bringing the matter to an end.

In further reasoning the decision did address the question of standing, the majority suggesting that other aspects of the legislation, such as there being no requirement to give notice of a decision to the public, and the potential delay from the 21 day period to lodge requests for reconsideration, also served to suggest that the legislation had no concern with broader public interests. However, these further considerations do not appear critical to the majority decision which rested on the narrow concept of what constituted a reviewable decision under s 119 of the DAA Act.

⁹¹ *Peter Allan v Development Allowance Authority* [1997] 738 FCA at 14.

VI THE STANDING OF 'STANDING' IN TAX DISPUTES

The function performed by statutory rules requiring a person to have standing to seek review of an administrative decision is to limit access to the courts or tribunals, by acting as a formal filter operated by the judiciary. Such a filtering device serves a number of purposes, including, among others, to preclude frivolous actions, to forestall the use of courts as a forum for espousing political ideology, and not least to deny access to the courts "to a mere busybody who is interfering in things which do not concern him."⁹²

The formal filter provided by the standing rules operates in addition to the more informal filters which operate to limit access to the courts, the most readily apparent being the cost of litigation. In the taxation context, such an informal filter operates to ensure that only those disputes which are genuine, and involve significant sums of tax in dispute, will proceed to the court system.⁹³

However, as noted in the earlier discussion, Part IVC of the Tax Administration Act provides a less costly and more readily available access for review of taxation decisions. These provisions deal with review not only of income tax decisions, but decisions in relation to all Commonwealth taxes, including goods and services tax and fringe benefits tax. With the review provisions being more readily accessible, and the increasing range of Commonwealth taxes falling for review under these provisions, the 'floodgates' argument would suggest that there would need to be some threshold mechanism for access to review, and this threshold is provided in this context by the rules for standing.

It would be expected that a taxpayer, or a taxpayer's representative, would normally meet the requirement for standing to seek review of a taxation decision in relation to the taxpayer's own affairs, no matter how narrowly the statute defined standing, or how narrowly the courts construed the requirement. The issue then becomes how wide a scope there is for other interested parties to be able to instigate a review of a taxation decision relating to another taxpayer, and under what circumstances another person may seek to have a taxation decision relating to a different taxpayer reviewed.

The discussion that follows raises some circumstances where such an issue may arise.

One situation where others would have an interest in the outcome of any existing taxation dispute of a taxpayer is in the area of bankruptcy and liquidation. The earlier discussion examined those cases which have held that a bankrupt taxpayer is an exception to the general rule, in that the taxpayer does not have standing to seek review of a taxation decision relating to the taxpayer's own affairs, but rather the trustee in bankruptcy has standing. This may appear an anomalous result in some ways, as it may not always be the case that the interests of the bankrupt taxpayer and the interests of the trustee in bankruptcy would coincide. As an example, the trustee in bankruptcy may not consider that review of an existing or putative taxation dispute would be worth pursuing, while the taxpayer may be better served by seeking review of an adverse taxation decision, as a successful outcome from the review may significantly ameliorate the financial distress of the taxpayer.

⁹² *R v Greater London Council; Ex parte Blackburn* [1976] 1 WLR 550, Lord Denning at 559.

⁹³ The Australian Taxation Office test case program will also allow for cases involving small amounts of tax in dispute, but which involve a significant issue of law, will be an exception to this; see for example *FCT v McNeil* (2007) HCA 5 which involved a sum of around \$500 but proceeded to the High Court.

Further to this example, the issue also arises as to whether standing would be available to a creditor in the liquidation of a taxpayer. It may well be that creditors could be 'dissatisfied' or 'aggrieved' in relation to an adverse taxation decision affecting the taxpayer, and a reversal of the taxation decision on review may have a significant impact on the potential outcome from the liquidation, thus giving the creditors an interest in the dispute. If the taxpayer is denied standing to seek review of the decision, and the trustee in bankruptcy or liquidator decides against seeking review of the adverse taxation decision, the creditors may wish to seek review of the adverse taxation decision. However, a narrow interpretation of the standing requirement would see creditors precluded from being granted standing to pursue review of the decision, even though their interests are affected.

Another situation where one taxpayer would have an interest in the outcome of a taxation dispute involving another taxpayer potentially arises in relation to entities with some common ownership. While the consolidation provisions, which effectively treat a group with common ownership as a single entity, may limit the cases where this could arise, not all commonly owned groups would be consolidated. Even if a group has consolidated, there may be an entity with some common ownership which is not part of the group as it does not satisfy the taxation grouping rules.

If one of the entities subject to common ownership was subject to an adverse taxation decision, but was not seeking review of the decision, it may be arguable that a related entity could also be 'dissatisfied' or 'aggrieved' by the decision as the effects of the taxation decision could impact adversely on the related entity. In such a case the related entity may wish to instigate review of the adverse taxation decision. It may be expected that the narrow approach to standing taken by the courts would suggest that the courts would be reluctant to allow a related entity to seek review of a taxation decision relating to the taxpayer, even though the interests of a related party may be detrimentally affected by the taxation decision relating to the taxpayer.

While the scope to be afforded to the standing rules in relation to taxation decisions remains to be fully tested in the courts, the judicial considerations in relation to standing in taxation cases to date would suggest that the courts have been adopting a narrow approach to the interpretation of the standing provisions. However, as the simple examples illustrate, there may be an argument for a broadening of the application of the standing rules where taxpayers, other than the taxpayer subject to the taxation decision, are adversely impacted by the taxation decision.

VII CONCLUDING REMARKS

The question remaining as a result of the court deliberations in the cases is whether the arguably narrow legislative interpretations can be reconciled with the ideals of transparency and accountability of administrative decision making.

In looking to the legislative provisions considered in this case, there would appear to be a clear progression in that the threshold conditions for review become more demanding at higher levels in the review hierarchy. For reconsideration of a DAA decision, as provided in s 119 of the DAA Act, the requirement is "a person who is affected by a reviewable decision." Section 121 of the DAA Act provided for further recourse to the AAT where threshold conditions had been met, the requirement from s 27(1) of the AAT Act being a person "whose interests are affected". The wording of the provisions suggests a gradation in scale from the DAA Act to the AAT Act, which would be expected as the review process progresses further up the hierarchy.

As noted by Kirby J, this view is reinforced when looking to the next level of review under the terms of the ADJR Act, the threshold requirement for which is prescribed in s 5(1) of the ADJR Act as being a “person who is aggrieved by a decision.” This again connotes a more stringent requirement at higher levels of review.

The reconsideration sought in this case was by the DAA, where it might be expected that a ‘person who is affected by a reviewable decision’ would be given a wide reading and interpretation, reflecting the fact that this body sat at the base level of the review hierarchy.

However the Courts at each level declined to adopt a broad interpretation, in each case limiting the scope of the provision, although as noted above, arguably for different reasons. The result from such a constricting interpretation is to “... (authorise) administrators, by the very substantial decisions they make, to place themselves beyond external review.”⁹⁴

Given that Parliament has the power to constrain or restrict external review if such is its intention, it may be seen as a surprising result that where Parliament has not done this by clear language, the assumption being that the intention is to leave scope for the operation of the administrative law review provisions, the Courts have nevertheless been prepared to apply a narrow interpretation and constrict administrative review. Such an approach would appear to be at odds with the intent of the rationale behind the administrative review regime, and it remains to be seen whether provisions hailed as providing transparency and accountability continue to do so, or are emasculated by narrow literal interpretations.

⁹⁴ *Allan v Transurban City Link Ltd* [2001] HCA 58 per Kirby J at para 88.

RELIANCE CARPET CO PTY LTD: WAS THE FULL FEDERAL COURT RIGHT?

MAHESWARAN SRIDARAN*

The taxpayer granted an option to a prospective purchaser for the purchase by the latter of a property owned by the taxpayer. Under the option, the taxpayer received a security deposit from the prospective purchaser, subsequent to which the taxpayer entered into a contract with the prospective purchaser for the sale of the property. The purchase was not completed by the prospective purchaser, and the deposit was forfeited. The Commissioner assessed the taxpayer for GST payable on the forfeited deposit, but the taxpayer objected to the assessment, an objection which the Commissioner disallowed. The taxpayer then appealed to the Administrative Appeals Tribunal, which disallowed the appeal. The taxpayer then appealed to the Full Federal Court, which unanimously allowed the appeal. This article argues that the Full Federal Court's decision was wrong. It argues so on either of two grounds: the Full Federal Court erred on drawing the proper conclusion on applying the relevant legislative provisions to the facts; or it applied a method of statutory interpretation (under the purposive approach) which was not the best. The submissions made on behalf of the Commissioner to the Full Federal Court did not include the first of those two grounds. Those submissions did include the second, but not underpinned by the analysis articulated in this article. The Commissioner was granted special leave by the High Court to appeal the Full Federal Court's decision. It was subsequently announced that he would appeal to the High Court. In a postscript to this article it is noted that the High Court has since unanimously overturned the decision of the Full Federal Court in Reliance.

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I INTRODUCTION

This article argues that the decision of the Full Federal Court in *Reliance Carpet Co Pty Ltd v Commissioner of Taxation*¹ ('the *Reliance* case') was wrong.

A Facts

Reliance Carpet Co Pty Ltd ('the taxpayer') granted, for a price of \$25,000, 699 Burke Road Pty Ltd ('the prospective purchaser') an option ('the option') to buy a property that the taxpayer owned. The option required that, on the option being exercised, the prospective purchaser pays the taxpayer \$297,500, which was to be a deposit in respect of the purchase price of the property (\$3 million minus the option fee of \$25,000).

The prospective purchaser exercised the option, but failed to pay timely to the taxpayer the deposit of \$297,500. The prospective purchaser did eventually pay the deposit on being required by the taxpayer to do so. Thereafter, the taxpayer and the prospective purchaser entered into a contract for the sale of the property. The contract provided that the remainder of the purchase price of \$2,677,500 was payable to the taxpayer by the prospective purchaser on settlement.

The prospective purchaser failed to complete settlement on the due date (that due date being the date, as appointed in the contract, extended by some 6 months, on the prospective purchaser choosing such an extension, as the prospective purchaser was contractually entitled to). The taxpayer, then, as allowed under the contract, served on the prospective purchaser a rescission notice requiring completion of settlement within 14 days. The prospective purchaser failed to respond to that rescission notice. The contract was then, as allowed under the contract, on or about 26 July 2003, rescinded, and the deposit was forfeited to the taxpayer.

The prospective purchaser requested of the taxpayer a tax invoice in respect of the forfeited deposit, which the taxpayer refused to provide. The Commissioner assessed the taxpayer in respect of GST payable on the forfeited deposit for the tax period of three months ended 30 September 2003. The taxpayer objected to the assessment. The taxpayer's objection was disallowed by the Commissioner. The taxpayer appealed that decision to the Administrative Appeals Tribunal, which disallowed the appeal. The taxpayer then appealed to the Full Federal Court, which unanimously allowed the appeal.

II FULL FEDERAL COURT'S ANALYSIS

All legislative references below are, unless otherwise stated, to the GST Act.²

A Did the contract involve making some supplies until the transfer of the property?

The Full Federal Court, which delivered a single, joint judgement, did not accept the following analysis adopted by the Administrative Appeals Tribunal:

The ultimate obligation was of course to transfer title to the purchaser upon payment of the balance of purchase price. But there were other obligations, such as maintaining the property

¹*Reliance Carpet Co Pty Ltd v Commissioner of Taxation* [2007] FCAFC 99 (5 July 2007) ('*Reliance*').

²*A New Tax System (Goods and Services Tax) Act 1999* (Cth).

in its present condition ..., to pay all rates, taxes, assessments, fire insurance premiums and other outgoings in respect of the land ... and to hold the existing policy of fire insurance for itself and in trust for the purchaser to the extent of their respective interests ... In the circumstances it may be fairly said that upon the execution of the contract the applicant made a supply in that, in terms of s 9-10(2)(g) of the GST Act, “it entered into an obligation” to do things it was bound to do under the contract and further that the deposit was consideration for a supply in that it was a “payment in connection with a supply” (s 9-15(1)(a)).”³

The Full Federal Court described that analysis of the Administrative Appeals Tribunal as having ‘an artificial resonance to it’.⁴ The Full Federal Court, in that respect, reasoned that:

When the applicant entered into the contract for sale with the purchaser it entered into a contract for the supply of real property; nothing more nothing less. ... That supply did not take place because the contract was rescinded. However, the fact that that supply did not take place is not a warrant to undertake some juristic dissection of the contract to find some other supply, in terms of the GST Act, at the time of entry into the contract. In our view, there was no supply of interim obligations either then or subsequently.⁵

The Full Federal Court cited as authority for that reasoning passages from *Hallstroms Pty Ltd v Commissioner of Taxation*⁶ and *Commissioner of Taxation v Raymor (NSW) Pty Ltd*.⁷

B *Were there supplies made on the rescission of the contract?*

The Full Federal Court concluded that ‘[t]he mere extinguishment of contractual rights would not ... fall within the ordinary meaning of “supply”’.⁸ The Full Federal Court cited as authority for that conclusion passages from *Westley Nominees Pty Ltd v Coles Supermarkets Australia Pty Ltd*.⁹ In that respect, the Full Federal Court reasoned:

...[O]n the breach of the contract by the purchaser, including its failure to pay the balance of the purchase price when due, the applicant did not have the right to elect to rescind the contract. Rather, the applicant had the right to issue a rescission notice which had the effect, upon the failure of the purchaser to remedy the default within the stated period, of determining the contract. By issuing the rescission notice, the applicant did not surrender any rights or release the purchaser from any obligations. Neither on the occasion of the issue of the notice nor on the effluxion of time in which to cure the default was there a “supply” by the applicant to the purchaser.¹⁰

C *Can Division 99 apply where there is no supply?*

While acknowledging that legislation must be interpreted purposively,¹¹ the Full Federal Court noted that ‘[t]he legislative purpose underlying Division 99 is not readily apparent from the language of the Division itself.’¹² After considering the

³ *Reliance Carpet Co Pty Ltd v Commissioner of Taxation* [2006] AATA 486 (5 June 2006), para 17.

⁴ *Reliance* [2007] FCAFC 99, para 16.

⁵ *Reliance* [2007] FCAFC 99, para 18.

⁶ *Hallstroms Pty Ltd v Commissioner of Taxation* (1946) 72 CLR 634, 648.

⁷ *Commissioner of Taxation v Raymor (NSW) Pty Ltd*. (1990) 24 FCR 90, 99.

⁸ *Reliance* [2007] FCAFC 99, para 20.

⁹ *Westley Nominees Pty Ltd v Coles Supermarkets Australia Pty Ltd*. (2006) 152 FCR 461, para 16.

¹⁰ *Reliance* [2007] FCAFC 99, para 21.

¹¹ *Reliance* [2007] FCAFC 99, para 22.

¹² *Reliance* [2007] FCAFC 99, para 23.

comments in the Explanatory Memorandum¹³ that relate to div 99, the Full Federal Court concluded that s 99-5 never operates so as to make a forfeited deposit liable to GST, since that forfeited deposit can never be consideration for a taxable supply.¹⁴ That is so, the Full Federal Court reasoned, as no supply had occurred because the contract for which that deposit was paid as security was not consummated.¹⁵

D Does the decision reached accord with the overall policy rationale of the GST?

The Full Federal Court concluded that the decision it thus reached—the taxpayer was not liable to GST on the forfeited deposit—was not ‘inconsistent with the legislative purpose’ of the GST,¹⁶ which was to be ‘a tax on private consumption in Australia’.¹⁷

III WHY THE FULL FEDERAL COURT’S ANALYSIS IS WRONG

A On what grounds can the Full Federal Court’s analysis be found to be wrong?

The Full Federal Court’s analysis, and its decision, can be critiqued as being wrong on either of two grounds:

- the Full Federal Court erred on drawing the proper conclusion on applying the relevant legislative provisions to the facts; or
- it applied a method of statutory interpretation (under the purposive approach) which was not the best.

The submissions made on behalf of the Commissioner to the Full Federal Court did not include the first of those two grounds. Those submissions did include the second, but not underpinned by the analysis articulated in this article.

B Were the proper conclusions drawn on the application of the law to the facts?

Paying proper regard to the facts of the *Reliance* case, what would be the commonsensical answer to the straightforward question: why was the taxpayer paid a deposit of \$297,500 by the prospective purchaser? The answer comprises two parts: first, the deposit was paid because the prospective purchaser was required, under the option, to pay it to the taxpayer, so as to bind the taxpayer to enter into a contract for the sale of a property to the prospective purchaser; and, second, it was paid so on the understanding that it will be treated as a part payment of the price payable for the property.

The existence of the second part—that is, the deposit paid is to be treated as a part payment of the price payable for the property to be bought by the prospective purchaser—does not detract from the first part, that is, the deposit was also paid because the prospective purchaser was required, under the option, to pay it to the taxpayer so as to bind the taxpayer to enter into a contract for the sale of the property to the prospective purchaser. If the second part comes to pass, by the terms of the

¹³ Explanatory Memorandum, A New Tax System (Goods and Services Tax) Bill 1998 (Cth).

¹⁴ *Reliance* [2007] FCAFC 99, para 25.

¹⁵ *Reliance* [2007] FCAFC 99, para 26.

¹⁶ *Reliance* [2007] FCAFC 99, para 31.

¹⁷ *Ibid.*

contract, the deposit wholly becomes a part payment of the price payable for the property, with no part of the deposit made referable to anything else, including the first part. That, however, does not mean that the first part does not exist. It does; legally and substantively, it does.

In the rest of this article, those two parts are referred to respectively as ‘the first part’ and ‘the second part’, as those two expressions have been used in the two paragraphs just above.

Does the first part give rise to a ‘supply’ by the taxpayer? It does.

The expression ‘supply’ is defined in s 9-10 as:

- (1) A supply is any form of **supply** whatsoever.
- (2) Without limiting subsection (1), **supply** includes any of these:
 - ...
 - (g) an entry into, ... an obligation:
 - i) to do anything;
 - ...

The entry by the taxpayer into a contract for the sale of the property to the prospective purchaser is thus a ‘supply’ in terms of s 9-10(2)(g), if not s 9-10(1).

The deposit paid to the taxpayer by the prospective purchaser under the option is, correspondingly, ‘consideration’ received by the taxpayer for that supply. That is so as that deposit is captured by the definition of the expression ‘consideration’ in s 9-15(1)(a), a definition which includes, as ‘consideration’, ‘any payment ... in connection with a supply of anything’.

The position noted in the paragraph just above, however, is subject to div 99 (as canvassed below).

GST is payable on ‘taxable supplies’¹⁸. That is so as s 9-5 provides that a taxpayer makes a taxable supply if that taxpayer ‘make[s] [a] supply for consideration’ (not being either an input-taxed supply or a GST-free supply). Subject to div 99, therefore, under the first part, there is a taxable supply made by the taxpayer. That is because the taxpayer has entered into a contract for the sale of the property to the prospective purchaser (which amounts to the making of a ‘supply’ by the taxpayer) for ‘consideration’ (which is the receipt by the taxpayer of the deposit).

Given that the deposit is subject to the second part, div 99 become applicable. The applicability of div 99, however, is limited to the treatment of the deposit as ‘consideration’—specifically, to the circumstances in which the deposit can be treated as consideration, and the time at which the deposit can be so treated as consideration.

The two relevant sections of div 99 read:

99-5 Giving a deposit as security does not constitute consideration

- (1) A deposit held as security for the performance of an obligation is not treated as *consideration for a supply, unless the deposit:
 - (a) is forfeited because of a failure to perform the obligation; or
 - (b) is applied as all or part of the consideration for the supply.
- (2) This section has effect despite section 9-15 (which is about consideration).

¹⁸ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 7-1(1).

99-10 Attributing the GST relating to deposits that are forfeited etc.

(1) The GST payable by you on a *taxable supply for which the consideration is a deposit that was held as security for the performance of an obligation is attributed to the tax period during which the deposit:

- (a) is forfeited because of a failure to perform the obligation; or
- (b) is applied as all or part of the consideration for a supply.

(3) This section has effect despite section 29-5 (which is about attributing GST for taxable supplies).

Division 99 does three things:

- it prescribes the manner in which the deposit must be dealt with by the taxpayer if the deposit were to be treated as consideration: s 99-5(1);
- it prescribes when (that is, in which tax period) the deposit is so treated as being consideration: s 99-10(1); and
- it prescribes that the deposit is so treated as being consideration only if the supply in relation to which the deposit was received is a taxable supply: s 99-10(1).

It thus follows (due to ss 99-5 and 99-10) that, when the deposit of \$297,500 is forfeited to the taxpayer, the taxpayer becomes liable to GST on that deposit in the tax period in which that forfeiture occurs. That is so as that forfeited deposit is consideration for a 'taxable supply', being the entry by the taxpayer into a contract for the sale of the property to the prospective purchaser (a supply which is neither an input-taxed supply nor a GST-free supply).

Section 99-5(1)(a) captures the deposit forfeited to the taxpayer as:

- the deposit is 'held as security for the performance of an obligation' (the 'obligation' being the prospective purchaser buying the property from the taxpayer); and
- the deposit 'is forfeited because of a failure to perform the obligation'.

Section 99-10(1)(a) also captures the deposit forfeited to the taxpayer as:

- there must be a 'taxable supply for which the consideration is a deposit': which there is, as the deposit is, under the first part, 'consideration' for a 'taxable supply' (being the entry by the taxpayer into a contract for the sale of the property to the prospective purchaser, for which the taxpayer received the deposit);
- the deposit is 'held as security for the performance of an obligation' (the 'obligation' being the prospective purchaser buying the property from the taxpayer); and

- the deposit ‘is forfeited because of a failure to perform the obligation’.

In formulating the analysis that has been just articulated, the expression ‘consideration’ used in s 99-10 cannot be taken as being controlled by the provision made in s 99-5 as to ‘consideration’. That is so as to reason otherwise would be circular.

The deposit was, as described earlier, under the first part, paid, as required by the option, to bind the taxpayer to enter into a contract for the sale of the property to the prospective purchaser. It was that circumstance (that is, the presence of the first part) which resulted in the analysis articulated above. It may, however, well happen that, in a different case, the first part may not be present, and all that is present will be the second part. Though that was, as will be clear from the description thus far, not so in the *Reliance* case, the case was seemingly argued before the Full Federal Court as if that had been so. However, even if that had been so, the taxpayer must be required to pay GST on the forfeited deposit, for the reasons canvassed below.

C Was the Full Federal Court’s approach to statutory interpretation the best?

As noted earlier, the Full Federal Court did acknowledge that legislation should be interpreted purposively. Did it, however, interpret so? It did not, as argued below.

Section 15AB of the Acts Interpretation Act¹⁹ provides:

(1)... in the interpretation of a provision in an Act, if any material not forming part of the Act is capable of assisting in the ascertainment of the meaning of the provision, consideration may be given to that material:

...

(b) to determine the meaning of the provision when:

...

(ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.

(2) Without limiting the generality of subsection (1), the material that may be considered in accordance with that subsection in the interpretation of a provision of an Act includes:

...

(e) any explanatory memorandum relating to the Bill containing the provision ... that was laid before, or furnished to the members of, either House of the Parliament by a Minister before the time when the provision was enacted;

...

The Full Federal Court observed:

The legislative purpose underlying Division 99 is not readily apparent from the language of the Division itself. On the one hand, it seems clear enough that the legislature intended to defer the time at which a deposit (held as security for the performance of an obligation) could be taken to be all or part of the consideration for a supply until completion of the contract under which the deposit is paid; at that time, the deposit is actually applied as part of the consideration for the supply. In this way s 99-5(1)(b), in conjunction with s 99-10(1)(b), overcomes the general attribution rule in Division 29 which would, in the case of a taxable supply, trigger the vendor’s GST liability on the payment by the purchaser of the deposit. But where the deposit is forfeited because of a failure to perform the obligation, what does the language of the Division say about the underlying legislative policy or purpose? Is it to subject to GST all such forfeited deposits irrespective of whether or not the supply, which would have occurred if the contract had been completed, would be a taxable supply? Or is it to subject to

¹⁹Acts Interpretation Act 1901 (Cth) s 15AB.

GST only those forfeited deposits where the supply, which would have occurred had the contract been completed, would have been a taxable supply?²⁰

Accepting that the underlying legislative purpose was to subject to GST only those forfeited deposits where the supply, which would have occurred had the contract been completed, would have been a taxable supply, the question which arises is whether the language of s 99-5 permits a construction which accommodates that result. In our view, for the reasons set out below [reproduced later in this article], it does not.²¹

Those observations of the Full Federal Court amount to ‘the ordinary meaning conveyed by the text of the provision [s 99-5] taking into account its context in the Act and the purpose or object underlying the Act lead[ing] to a result that is manifestly absurd or is unreasonable’. That is so as ‘the purpose or object underlying the Act’ is to make a taxpayer that is required to register for GST liable to GST on only ‘taxable supplies’ made by that taxpayer. The Full Federal Court, then, on the authority of s 15AB of the Acts Interpretation Act, may have considered the comments in the relevant Explanatory Memorandum, which it did. That approach of the Full Federal court is evinced by the passages from its judgment quoted later.

The Explanatory Memorandum²² commented:

6.165 ... [S]ome security deposits later become incorporated in the consideration for a taxable supply. At some point the deposit ceases to be held as a security deposit and is offset against the remaining consideration that is payable. GST should be charged on such deposits if they become part of the consideration for the taxable supply.

6.166 Also if a security deposit made in relation to a taxable supply is forfeited, GST should be payable on the deposit.

Those two paragraphs in the Explanatory Memorandum, when read together, in a commonsensical manner, in the context of the *Reliance* case, can result in only one view: that is, that the taxpayer is liable to GST on the forfeited deposit, where that deposit was received by the taxpayer ‘in relation to a taxable supply’ had the taxpayer have had to make that supply. Perhaps, in order to reach that view, the Full Federal Court may have had to (but not necessarily) interpolate the words ‘actual or potential’ just before the word ‘taxable’ in para 6.166 of the Explanatory Memorandum. It did have ample warrant to do that interpolation (if it thought it necessarily had to).

Or, the Full Federal Court could have, on the authority of para 6.166 of the Explanatory Memorandum, interpolated the words ‘actual or potential’ just before the word ‘taxable’ in s 99-10(1). That interpolation, too, it did have ample warrant to do.

Any other view (such as the view reached by the Full Federal Court) will render para 6.166 of the Explanatory Memorandum largely (if not wholly) devoid of purpose.

The Full Federal Court justified its view thus:

At best, s 99-5 allows a forfeited deposit to be treated as consideration for an unidentified supply. But if a supply for which the forfeited deposit can be treated as consideration cannot be identified, s 99-5 has no work to do. The Commissioner’s submissions, in the alternative, that s 99-5 not only allows the forfeited deposits to be treated as consideration for a supply, but also deems there to be a supply is, in our view, not open on the language of the section. Even if it was, it would not go far enough to accommodate the legislative purposes identified

²⁰ *Reliance* [2007] FCAFC 99, para 23.

²¹ *Reliance* [2007] FCAFC 99, para 25.

²² Explanatory Memorandum, A New Tax System (Goods and Services Tax) Bill 1998 (Cth).

above—to tax forfeited deposits paid in relation to unconsummated taxable supplies but not tax them if paid in relation to unconsummated supplies which were not taxable supplies.²³

Moreover, if s 99-5(1) was intended to operate to deem a supply in addition to allowing the deposit to be treated as consideration for a supply, one would have expected that s 99-5(2) would have said: “This section has effect despite section 9-10 [which is about supply] and despite section 9-15 [which is about consideration.” It only refers to the latter.²⁴

That justification (by the Full Federal Court) loses relevance when one accepts that the better method of statutory interpretation (under a purposive approach) is to interpolate, on the authority of para 6.166 of the Explanatory Memorandum, the words ‘actual or potential’ just before the word ‘taxable’ in s 99-10(1). In order to do that interpolation, which the Full Federal Court did have ample warrant to do, the Full Federal Court may have had to (but not necessarily) interpolate the words ‘actual or potential’ just before the word ‘taxable’ in para 6.166 of the Explanatory Memorandum. The latter interpolation, too, is one which the Full Federal Court did have ample warrant to do.

The Full Federal Court supported its approach as to the interpretation of s 99-5 with reference to two authorities: *Network Ten Pty Ltd v TCN Channel Nine Pty Ltd*²⁵, and a paper titled *To interpret or translate? The judicial role for GST case*.²⁶

Passages, which the Full Federal Court cited in support, from those two authorities are:

I accept wholeheartedly that the contemporary approach of this court to the interpretation of contested statutory language is the purposive approach. However, adopting that approach does not justify judicial neglect of the language of the statute, whether in preference for historical or other materials, perceived legal policy or any other reason. A purposive construction is supported by s 15AA of the Acts Interpretation Act 1901 (Cth). But that section also does not permit a court to ignore the words of the Act. Ultimately, in every case, statutory construction is a text-based activity. It cannot be otherwise.²⁷

It is not often that the courts are given the opportunity of interpreting legislation providing for the implementation of an entirely new tax and especially one which is intended to operate broadly over the entire sphere of economic activity. The tools which permit judges to interpret in a purposive way with an eye to ensuring that the tax works as it may be assumed to be intended to work in the real world are there, but with one exception. There will obviously be unintended consequences which arise in the implementation of a new tax drafted in a way which in many respects differs from comparable legislation in other jurisdictions. While, in part, such unintended consequences can be dealt with by the ruling system that is not a satisfactory long-term solution to problems. There is a need for the legislature to cure defects from time to time. Yet there seems to be a refusal on the part of government to admit there are defects and to make amendments other than amendments which may be thought necessary to overcome avoidance. In some case, the courts may be able to resolve difficulties by applying a purposive construction but in the Australian constitutional context where there is a sharp separation of the legislative and judicial powers there is a limit to what one can expect of the courts. Ultimately the courts can not act as legislators. Parliament can not stand by and then blame the courts if a decision is one that does not favour the revenue when the problem lies not in how the legislation is to be interpreted in a common sense way, but in how it is written.²⁸

²³ *Reliance* [2007] FCAFC 99, para 26.

²⁴ *Reliance* [2007] FCAFC 99, para 27.

²⁵ *Network Ten Pty Ltd v TCN Channel Nine Pty Ltd* (2004) 218 CLR 273.

²⁶ Justice Graham Hill, ‘To interpret or translate? The judicial role for GST cases’ (Paper presented at a conference organised by Monash University on ‘Interpreting GST law’, Sydney, 5 August 2005).

²⁷ *Network Ten Pty Ltd v TCN Channel Nine Pty Ltd* (2004) 218 CLR 273, per Kirby J, 305-306.

²⁸ Hill, above n 26.

Both of those authorities, however, do not mandate a disregard for comments in a relevant explanatory memorandum as clear in their purported object (on a commonsensical view) as found in para 6.166 of the Explanatory Memorandum.

In any event, both of those authorities cannot, by any means, be taken as representing a definitive approach to statutory interpretation that has uniform application. There is copious authoritative literature which credibly demonstrates that, in practice, there is no single definitive approach to statutory interpretation. And that what happens in practice, when judges undertake statutory interpretation, is that judges choose, from a long menu of potential rationalisations, one or more rationalisations to support an interpretation those judges prefer.²⁹ The two authorities (as referred to above) relied upon by the Full Federal Court, therefore, represent no more than one of many such potential rationalisations that can be chosen by judges to support an interpretation they prefer.

The analysis articulated above, as noted earlier, is premised on the presence only of the second part (but not the first part). That was, as mentioned earlier, the premise on which the *Reliance* case was seemingly argued before the Full Federal Court. The proper analysis if the first part is present (as it was in the *Reliance* case) has already been articulated.

The approach advanced in this article as the proper approach to interpreting s 99-5 does, indeed, have rigorous, coherently articulated (and thus authoritative) literature in support of it, literature which is canvassed below.

In an article, well-argued with reference to judicial and legislative authorities, published in 2000,³⁰ the current Commissioner, Michael D'Ascenzo, who was a Second Commissioner of Taxation at the time of writing that article, observed:

Resignment to the proposition that effective implementation of the tax law is possible only with an all-knowing and infallible legislator (which does not exist in reality), ... is likely to lead to a sub-optimal, and in some cases dysfunctional operation of the community's tax laws.
...³¹

There is also much to be said for the view that "[judges, as final arbiters in the implementation process, should thus assume responsibility for ensuring that legislation is as coherent as possible."³²

Understanding this reality, the courts have taken a purposive approaches to the interpretation of statutes or have intervened to fill a gap in the legislation, where they have considered there was good reason to do so, taking into account "considerations of logic, common-sense, and policy." ... Courts have preferred alternative constructions, or have had regard to underlying issues even where "incautious expression" does not appear to deal with them. ... This is particularly so where a literal approach would produce a result that would be "incongruous, contrary to the objects of the Act, capricious or irrational" ... or 'where the ordinary meaning is manifestly absurd, or unreasonable such that Parliament could hardly have intended that result, so that some other meaning should be preferred' ... or "where the literal or

²⁹ For a readily accessible analysis, see, for instance, Ruth Sullivan, 'The plain meaning rule and other ways to cheat at statutory interpretation', *Legal Drafting* < <http://aix1.uottawa.ca/~resulliv/legdr/pmr.html> > at 25 September 2006; and Karl N Llewellyn, 'Remarks on the theory of appellate decision and the rules or canons about how statutes are to be construed', (1950) 3 *Vanderbilt Law Review*, 395.

³⁰ Michael D'Ascenzo, M, 'Along the road to Damascus: A framework for interpreting the tax law', *Journal of Australian Taxation* (November/ December 2000), 384.

³¹ *Ibid*, 385.

³² *Ibid*, 385.

grammatical meaning gives rise to an injustice, or even in some cases to an anomaly or inconvenience, which may mean that parliament did not intend that meaning to prevail; ... or where the words are susceptible to an alternative construction and the construction is “more consonant with good sense” and the “commercial realities” ... of the situation or more in accord with “logic and policy”.³³

Responsible and measured judicial approaches and interventions of this nature allow the tax system to operate with a sense of equity and efficiency, and promote substantive equality of treatment. ... They reflect an acceptance of the responsibility to ensure that if “the courts can identify the target of parliamentary legislation their proper function is to see that it is hit; not merely to record that it has been missed.”³⁴

A distinguished Canadian tax law professor, Neil Brooks, in two works, has developed an approach to interpreting tax laws largely consistent with that advocated by D’Ascenzo. Those two works are *The responsibility of judges in interpreting tax legislation*,³⁵ and *Statutory interpretation as incremental policy-making: Illustrated by reference to Canadian GST cases*.³⁶ In the latter, which builds on the former, Brooks advocates what he describes as a ‘consequentialist’ approach to statutory interpretation, an approach which he justifies thus:

clarifying what a consequentialist approach to statutory interpretation entails is to note that my position is that in filling a gap (or resolving any question in dispute) in the legislation judges should engage in the same reasoning process as by tax policy analysts in the treasury department have had engaged in if the Minister had asked them to clarify the meaning of the statute on the issue in dispute. Instead of attempting to divine the plain meaning of words, or the legislative intent or purpose, the judge should act as a tax policy analyst.³⁷

... [T]he commentator on statutory interpretation who I have taken most comfort from is Richard Posner, the Chief Judge of the US Court of Appeals for the Seventh Circuit, pioneer of the law and economics movement, and prolific author on almost every subject and many public policy issues, including statutory interpretation. He is the leading advocate of the view that consequences should matter to a theory of legal interpretation. ... He has suggested that statutory interpretation might proceed by examining consequences alone: “Maybe the best thing to do when a statute is invoked is to examine the consequences of giving the invoker what he wants and then estimate whether those consequences will on the whole be good ones.” ...³⁸

The difference between what I am referring to as the consequentialist approach and the purposive approach is only a matter of degree. ... [U]nder the consequentialist approach the ... [judges] ... [i]nstead of purporting to deduce their conclusion from the discovered purpose of the legislation, judges weigh the consequences of the application of the statute. Purposivists search through the legislative record to attempt to find explicit references to the purposes and aims that the legislators had in mind; consequentialists are more likely to derive the purpose of the statute from the structure of the legislation and use of information from the legislative record to assist in analysing the consequences of alternative interpretations. The consequentialist approach places much more emphasis on facts and policy analysis in judicial decision-making. In deciding cases, judges have to consider not only the broad purposes of the legislation, but also all of the factors that would be considered by a policy analyst in the Revenue Department in formulating a rule to answer the adjudicated question: the ease with

³³ Ibid, 385 -386.

³⁴ Ibid, 386.

³⁵ Neil Brooks, ‘The responsibility of judges in interpreting tax legislation’, in Graeme S Cooper (ed) *Tax avoidance and the law* (Amsterdam: IBFD Publications BV, 1997), 93.

³⁶ Neil Brooks, ‘Statutory interpretation as incremental policy-making: Illustrated by reference to Canadian GST cases’ (Paper presented at a conference organised by Monash University on ‘Interpreting GST law’, Sydney, 5 August 2005).

³⁷ Ibid, 3.

³⁸ Ibid, 7.

which the implicit rule can be administered; the consequences of the holding for the achievement of horizontal and vertical equity, the likely effect of the holding on individual incentives, the effect of the holding on the government's ability to raise revenue, and the effect of the rule on tax avoidance and evasion behaviour.³⁹

The approach to statutory interpretation advocated by D'Ascenzo is a purposive approach, an approach which the Full Federal Court did adopt (but, as reasoned above, not correctly). The approach to statutory interpretation advocated by Brooks is a consequentialist approach, which Brooks, in the quotation just above, distinguishes from a purposive approach. In distinguishing so, though, Brooks concedes that the distinction can, in circumstances, be subtle, so as to, as in the *Reliance* case, be nearly non-existent when judged by the ultimate interpretive outcome resulting from either approach. Under either of those approaches, s 99-5 should have been interpreted by the Full Federal Court such as to make the taxpayer liable to GST on the forfeited deposit. That is so as that is the interpretive outcome that accords with the overall policy rationale underpinning the GST, an interpretive outcome which is the same reached under either a purposive approach or a consequentialist approach.

GST essentially is a tax on private consumption. Thus, producers are allowed to deduct from GST payable by them on their outputs the GST included in the cost of their inputs. That is so as, otherwise, there will be cascading of GST as inputs pass through the value chain (involving one or more producers) before they reach the final consumers in the form of finished outputs.

For that overall policy rationale underpinning the GST to be efficacious, every producer must pay GST on all its receipts. As, otherwise, there will be no GST paid on all private consumption. The taxpayer, in the context, was a producer, not a private consumer. It should, therefore, pay GST on all its receipts, including the forfeited deposit.

The Full Federal Court, as noted earlier, did acknowledge that 'the legislative purpose' of the GST⁴⁰ was to be 'a tax on private consumption in Australia'.⁴¹ Remarkably, however, as noted earlier, it concluded that its decision was not 'inconsistent'⁴² with that 'legislative purpose', without reasoning how it reached that conclusion. Perhaps, if it did, it will have realised that its decision was not right.

One cannot counter the argument just outlined to the effect that many supplies by producers are explicitly not liable to GST: for instance, supplies of residential accommodation, supplies made by suppliers who are not registered for GST, and financial supplies. Those supplies are not liable to GST not because it is not the overall policy rationale underpinning GST that every producer must pay GST on all its receipts. Rather, those supplies are not liable to GST so as to accommodate other subsidiary policy rationales, such as (in order) ameliorating the otherwise regressive impact the GST may have on users of residential accommodation, reducing the administrative burden that may otherwise be cast upon small businesses if they are made liable to GST, and recognising the practical difficulty to reliably measure the "value-added" by those making financial supplies.

³⁹ *Ibid*, 17.

⁴⁰ *Reliance* [2007] FCAFC 99, para 31.

⁴¹ *Reliance* [2007] FCAFC 99, para 31.

⁴² *Reliance* [2007] FCAFC 99, para 31.

IV CONCLUSION

For the reasons canvassed in this article, in the *Reliance* case, the Full Federal Court has surely erred badly. It erred so, this article has argued, on either of two grounds:

- it erred on drawing the proper conclusion on applying the relevant legislative provisions to the facts; or
- it applied a method of statutory interpretation (under the purposive approach) which was not the best.

The submissions made on behalf of the Commissioner to the Full Federal Court did not include the first of those two grounds. Those submissions did include the second, but not underpinned by the analysis articulated in this article. The Commissioner was granted special leave by the High Court to appeal the Full Federal Court's decision. It was subsequently announced that he would appeal to the High Court.

Postscript

The High Court has now unanimously overturned the decision of the Full Federal Court in *Reliance*.⁴³

The High Court concluded that, for GST purposes, there was a “supply” by the taxpayer [which] occurred before the forfeiture and thus before the provision of consideration ...’.⁴⁴ That ‘supply’, the High Court reasoned, was due to two reasons:

- *as correctly determined by the Administrative Appeals Tribunal, ‘upon execution of the contract the [taxpayer] made a supply in that, in terms of s 9-10(2)(g) ...it “entered into an obligation” to do the things it was bound to do under the contract’;*⁴⁵ and
- *‘within the meaning of par (d) of s 9-10(2) as extended by the definition of “real property”, there was upon exchange of contracts the grant by the taxpayer to the [prospective] purchaser of contractual rights exercisable over or in relation to land, in particular of the right to require in due course conveyance of the land to it upon completion of the sale’.*⁴⁶

⁴³ *Commissioner of Taxation v Reliance Carpet Co Pty Ltd* [2008] HCA 22 (22 May 2008) (*‘Reliance’*).

⁴⁴ *Reliance* [2008] HCA 22, para 37.

⁴⁵ *Reliance* [2008] HCA 22, para 37.

⁴⁶ *Reliance* [2008] HCA 22, para 37.