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FOREWORD

The papers included in this edition of the *Journal of the Australasian Tax Teachers Association (JATTA)* are based on presentations made at the 21st Annual Conference of the Australasian Tax Teachers Association (ATTA) held on Monday 19 January to Wednesday 21 January 2009 at the University of Canterbury, Christchurch, New Zealand. One paper was carried over from the 2008 ATTA Conference.

The Pro-Vice-Chancellor of the College of Business and Economics at the University of Canterbury, Professor Nigel Healey opened the conference and welcomed delegates. A Plenary presentation was given on the opening day of the conference by Professor Gordon Cooper, (Patron of ATTA). On the second day Plenary presentations were given by Honourable Justice William Young (President of the New Zealand Court of Appeal), Michael D'Ascenzo (Commissioner of Taxation), and Julia Hoare (Partner, PricewaterhouseCoopers). On the third day Plenary presentations were given by Robert Russell (Commissioner of Inland Revenue) and Professor Neil Brooks (Osgoode Hall Law School).

The conference theme 'Tax & Sustainability' generated considerable interest from tax academics, policy makers and practitioners across Australia and New Zealand and further abroad. The papers in this edition of *JATTA* demonstrate the significance of tax and sustainability, as well as other important issues across the spectrum of taxation. It is hoped that these papers will make a valuable contribution to the literature and stimulate the engagement and contribution of others, including students, to improving tax systems worldwide.

Finally, the efforts of many made the 21st Annual ATTA Conference the great success that it was and have culminated in the publication of this edition of peer reviewed papers. Sincere thanks to all those involved. With your ongoing support, ATTA will undoubtedly continue to thrive as a valued organisation.

Andrew Maples (University of Canterbury)

Adrian Sawyer (University of Canterbury)

10 December 2009

KEYNOTE ADDRESS

TAX DISPUTES IN NEW ZEALAND

HON JUSTICE WILLIAM YOUNG*

I OVERVIEW

When I was invited to present a paper at this conference, the topic was left to me (providing, of course, that it was about tax and ideally had a sustainability theme). “Free choice” of this kind usually puts me in state of terminal indecision. In this instance, however, I had no difficulty deciding on the New Zealand tax disputes process. The reason is simple enough. It is the area of tax law that I now know best and am most comfortable discussing with an audience of tax teachers. This, in turn, reflects what I regard as the dispiriting reality that most tax cases are about process.

It used to be very different. I was appointed to the bench in late 1997. For the preceding 19 years, tax advice and litigation formed an appreciable and, at times, significant part of my professional practice. During this time all I needed to know about the tax disputes resolution procedure could have been written on the back of an envelope.

The change between then and now has been immense. In this paper I will discuss why and how this change occurred and its practical implications and possible reforms and at the same time offer a gentle critique based on my current and admittedly limited perspective as an appellate judge. My discussion will focus primarily but not exclusively on the pre-assessment procedures which have attracted more debate than the post-assessment challenge process.

II A SHORT HISTORY

The relevant history is well known.¹ Prior to 1996, the statutory scheme for the resolution of tax disputes was simple. The key provisions were four sections in the Income Tax Act 1976² and three sections in the Inland Revenue Department Act 1974.³ The process was initiated by a letter of objection, which could be broadly expressed and thus in short form. The Commissioner was required to consider the objection. If the objection was not wholly allowed, the taxpayer could require the objection to be heard and determined by the Taxation Review Authority or, in some instances, by the High Court. The primary infelicity in legal framework (at least to my way of thinking) was that objections reached the High Court via the rather cumbersome case stated procedure. In practice, however, tax disputes were often drawn out over many years. I suspect

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¹ It is thoroughly discussed in G Blanchard, “The Case For A Simplified Tax Disputes Process” (2005) 11 *New Zealand Journal of Taxation Law and Policy* 417.

² Sections 30 – 33.

³ Sections 34 – 36.

that this was a function of a number of factors: some inefficiencies within the Inland Revenue Department; aspects of the system which at one time incentivised foot-dragging by taxpayers; and little or no case management of tax disputes within the court system.

In 1994, the Organisational Review Committee recommended major procedural changes.⁴ The Committee considered that insufficient care was being taken to ensure that assessments were correct before they were issued. A taxpayer who did not have a full understanding of the basis of an assessment could be expected to object in very general terms. The key areas of dispute were thus not necessarily identified at an early stage in the process. In practice, the officer responsible for the audit considered objections (although a decision to disallow an objection was made by a superior). The costs of the objection process were such that either the Department or taxpayers often conceded disputes. When litigation was pursued, the process could be inefficient, with judges required to determine cases which had not been appropriately considered at the assessment stage. As well, there were unacceptable delays associated with the resolution of tax disputes.

At the time, around 29 percent of objections were allowed in full and 19 percent were allowed in part. The Commissioner also conceded (at least in part) in 30 percent of the disputes in which a case stated was requested. The Committee's formal recommendations were in these terms:⁵

A revised tax disputes resolution process should be introduced with a revised approach to the pre-assessment phase.

Legislative changes should be made to introduce 'all cards on the table' and appropriate evidence exclusion provisions, to remove the legal requirement for a taxpayer to lodge an objection with the Commissioner and to provide for taxpayer initiated litigation to be subject to standard judicial timetabling.

A review of the operation of the new procedures for disputes resolution should be carried out two years after all the elements of the proposals are in place.

A simple, 'fast track', non-precedential procedure for dealing with small claims should be introduced as part of the jurisdiction of the Taxation Review Authority.

The Committee also expressed the following conclusion:⁶

The audit investigation and final quantification of liability should, as far as practicable, be clearly separated. The purpose is to provide an impartial application of tax law and greater application of technical expertise to the affairs of individuals prior to the issue of an assessment. In turn this will decrease the likelihood and grounds for disputes... .

The pre-assessment procedural recommendations of the Committee formed the basis of the 1996 amendments to the Tax Administration Act 1994 which inserted a new Part 4A into that Act. Section 89A(1) explained the purpose of the new Part:

(1) The purpose of this Part is to establish procedures that will—

⁴ Organisational Review Committee *Organisational Review of the Inland Revenue Department* (Wellington, April 1994).

⁵ See n 4, 70-71.

⁶ See n 4, 67.

- (a) Improve the accuracy of disputable decisions made by the Commissioner under certain of the Inland Revenue Acts; and
- (b) Reduce the likelihood of disputes arising between the Commissioner and taxpayers by encouraging open and full communication—
 - (i) To the Commissioner, of all information necessary for making accurate disputable decisions; and
 - (ii) To the taxpayers, of the basis for disputable decisions to be made by the Commissioner; and
- (c) Promote the early identification of the basis for any dispute concerning a disputable decision; and
- (d) Promote the prompt and efficient resolution of any dispute concerning a disputable decision by requiring the issues and evidence to be considered by the Commissioner and a disputant before the disputant commences proceedings.

As well, a new Part 8A was inserted into the Tax Administration Act which provided for challenge proceedings. The new procedures in operation were assessed in 2003⁷ and have been subject to some amendment. Most significantly, the amendments limit the discretion of the Commissioner to take short-cuts in relation to the pre-assessment dispute resolution process. This applies even where the time bar is imminent, although the Commissioner may apply to the High Court for permission to truncate the process.⁸ In this paper I address the relevant legislative provisions as they now stand, but it is important to recognise that most of the cases were decided under the less prescriptive procedures as introduced in 1996.

III THE PRE-ASSESSMENT DISPUTE PROCEDURE

A Commissioner initiated adjustments

The usual starting point is a notice of proposed adjustment (NOPA).⁹ Leaving aside cases where the small claims jurisdiction of the Taxation Review Authority is invoked,¹⁰ the next step is a notice of response (NOR),¹¹ in the absence of which the taxpayer is deemed to have accepted the NOPA.¹²

As a matter of practice (but not law), the NOR is usually followed by a conference.¹³ If a dispute is not resolved at a conference (because there is no conference or a conference is unsuccessful), the Commissioner must, except in specified circumstances,¹⁴ issue a disclosure notice together with his statement of

⁷ Inland Revenue Department *Resolving Tax Disputes: A Legislative Review* (Wellington, July 2003).

⁸ Section 89N(3). Where such an application is made, the time bar is extended until the application is determined, see s 89N(5).

⁹ Limited exceptions are provided for in s 89C.

¹⁰ See s 89E.

¹¹ Section 89G.

¹² Section 89H(1).

¹³ See SPS 08/01: *Disputes Resolution Process Commenced by the Commissioner of Inland Revenue* at [219] and ff.

¹⁴ See ss 89M(2) and 89N(1)(c).

position (SOP).¹⁵ The taxpayer is then required to issue the Commissioner with a SOP.¹⁶ SOPs must set out the facts, evidence and propositions of law on which the party intends to rely and must identify the issues the party considers will arise.

This exchange of documents triggers the evidence exclusion rule, which is found in s 138G(1) and (2). In simple terms, the rule limits the parties in any challenge to the facts, evidence, issues and propositions of law that are disclosed in the SOPs.¹⁷ Jurisdiction to allow a party to go beyond that disclosed is limited to where the omitted facts, evidence, issues or propositions of law could not have been, with due diligence, discovered or discerned at the appropriate time and their admission is necessary to avoid “manifest injustice”.¹⁸

In general, and with limited exceptions,¹⁹ the Commissioner must “consider” the taxpayer’s SOP before issuing an amended assessment.²⁰ The details of this consideration are not spelt out in the statute, but customarily involve a reference to the Inland Revenue Department’s Adjudication Unit.²¹ The courts, however, will not require the Commissioner to go through the conference and adjudication processes.²² As Mark Keating has pointed out,²³ in this respect the courts are less demanding than the Commissioner’s own policy statement (which indicates that, wherever practicable, all disputes must be referred to the Adjudication Unit).²⁴

If the Adjudication Unit’s decision is in favour of the taxpayer, it will be final. If not, the Commissioner will then issue an assessment that is in accordance with the Adjudication Unit’s determination. This assessment is then subject to the challenge procedure.

In cases that involve factual disputes, the utility of the adjudication phase (in which no attempt is made to resolve such disputes) is well open to question.²⁵ I should note that most of the cases that have so far come before the courts have not involved the disclosure notice/SOP processes.²⁶ So how the evidence exclusion rule will work in practice has yet to be seen.

B *Taxpayer-initiated disputes*

Broadly similar processes apply in the case of taxpayer-initiated disputes.²⁷ The original purpose of providing for taxpayer-initiated NOPAs was to provide for circumstances in which either the Commissioner had proceeded to an assessment without issuing a NOPA or the taxpayer wished to correct a

¹⁵ See s 89M(1) and (3).

¹⁶ See s 89M(5).

¹⁷ Section 138G(1).

¹⁸ Section 138G(2).

¹⁹ See s 89N(1)(c).

²⁰ See s 89N(2).

²¹ See n 20.

²² See *Commissioner of Inland Revenue v ANZ National Bank Ltd* (2007) 23 NZTC 21,167 (CA).

²³ M Keating “New Zealand’s Tax Dispute Procedure – Time for a Change” (2008) 14 *New Zealand Journal of Taxation Law and Policy* 425 at 442.

²⁴ Inland Revenue, SPS 08/01: *Disputes Resolution Process Commenced by the Commissioner of Inland Revenue* at [202].

²⁵ See J Coleman “Tax Update” [2007] *New Zealand Law Journal* 407.

²⁶ This is true for instance of *Commissioner of Inland Revenue v Zentrum Holdings Ltd* [2007] 1 NZLR 145 (CA).

²⁷ See Inland Revenue, SPS 08/02: *Disputes Resolution Process Commenced by A Taxpayer*.

mistake in a return.²⁸ In practice, however, this process is usually resorted to where the taxpayer has filed a conservative return and then seeks an adjustment. Adopting this approach has the advantage (from the point of view of the taxpayer) of avoiding penalties.²⁹

IV POST-ASSESSMENT PROCESSES

Part 8A of the Tax Administration Act provides for a challenge process under which the taxpayer may challenge an assessment either before the Taxation Review Authority or the High Court. It is clear enough that this process was intended by the legislature to be the primary – indeed those of a literal frame of mind might think the only – way of challenging an assessment. I say this given ss 109 and 114, which relevantly provide:

109 Assessments deemed correct except in proceedings

Except in... a challenge under Part 8A,—

- (a) No disputable decision may be disputed in a court or in any proceedings on any ground whatsoever; and
- (b) Every disputable decision and, where relevant, all of its particulars are deemed to be, and are to be taken as being, correct in all respects.

114 Validity of assessments

An assessment made by the Commissioner is not invalidated—

- (a) Through a failure to comply with a provision of this Act or another Inland Revenue Act; or
- (b) Because the assessment is made wholly or partially in compliance with—
 - (i) A direction or recommendation made by an authorised officer on matters relating to the assessment;
 - (ii) A current policy or practice approved by the Commissioner that is applicable to matters relating to the assessment.

Consistently with the recommendations of the Organisational Review Committee, a challenge in the High Court is now dealt with in the same way as other civil litigation. The implementation of this recommendation, along with the enactment of the care and management provisions of the Tax Administration Act,³⁰ have had major impacts on the way in which tax litigation is conducted. This is exemplified by:

The (now routine) use of discovery, in contradistinction to past practice;³¹

Changes in the practice as to costs³² and an associated recognition that the Commissioner is entitled to take a commercial approach to the settlement of tax litigation;³³ and

²⁸ Inland Revenue Department *Resolving Tax Disputes: A Legislative Review* (Wellington, July 2003) at 5.3.

²⁹ See n 1 at 425.

³⁰ See ss 6 and 6A.

³¹ Compare *Cates v Commissioner of Inland Revenue* [1982] 1 NZLR 530 at 533 (CA) per Cooke J, where the jurisdiction to order discovery was seen as one which would rarely be exercised and was appropriate only for “an occasional tax case”.

³² See *Auckland Gas Co Ltd v Commissioner of Inland Revenue* [1999] 2 NZLR 409 (CA).

³³ See for instance *Accent Management Ltd v Commissioner of Inland Revenue* (2007) 23 NZTC 21,366 (CA).

An open justice approach to publicity in relation to the affairs of taxpayers who litigate in the High Court.³⁴

Uncertainty remains as to the scope for judicial review in tax disputes. The New Zealand appellate decisions support the proposition that it is open to a taxpayer to challenge what purports to be an assessment which in fact does not represent the genuine assessment of the Commissioner as to the tax position of the taxpayer.³⁵ Generally the courts have accepted that the correctness of a tax assessment can only be challenged in challenge proceedings³⁶ and that judicial review is reserved for exceptional cases.³⁷ Running through the cases, however, has been something of a reluctance to treat ss 109 and 114 of the Tax Administration Act as meaning what they say. A taxpayer who seeks judicial review of an assessment might be thought to be disputing it and doing so in defiance of s 109(a). Section 109(b) deems an assessment to be “correct in all respects”, which might be thought to extend to its validity. On a literal approach it is difficult to reconcile the statutory requirement that a disputed assessment be taken as “correct in all respects” with judicial review on grounds of invalidity.

The relevant Australian legislative provisions (ss 175, 175A and 177 of the Income Tax Assessment Act 1936 (Cth)) are similar to ss 109 and 114 of the Tax Administration Act. Recently the High Court of Australia has re-emphasised the primacy of the objection and appeal processes, observing:³⁸

[24] Section 175 must be read with s 175A and s 177(1). If that be done, the result is that the validity of an assessment is not affected by failure to comply with any provision of the Act, but a dissatisfied taxpayer may object to the assessment in the manner set out in Pt IVC of the Administration Act; in review or appeal proceedings under Pt IVC the amount and all the particulars of the assessment may be challenged by the taxpayer but with the burden of proof provided in s 14ZZK and s 14ZZO of the Administration Act. Where s 175 applies, errors in the process of assessment do not go to jurisdiction and so do not attract the remedy of a constitutional writ under s 75(v) of the Constitution or under s 39B of the Judiciary Act.

[25] But what are the limits beyond which s 175 does not reach? The section operates only where there has been what answers the statutory description of an “assessment”. Reference is made later in these reasons to so-called tentative or provisional assessments which for that reason do not answer the statutory description in s 175 and which may attract a remedy for jurisdictional error. Further, conscious maladministration of the assessment process may be said also not to produce an “assessment” to which s 175 applies. Whether this be so is an important issue for the present appeal.

In effect the Court confined judicial review to two circumstances: first, where what is said to be an assessment is not in truth an assessment; and secondly, where there has been conscious maladministration. These two concepts were, to

³⁴ See for instance *Muir v Commissioner of Inland Revenue* (2004) 21 NZTC 18,894 (CA).

³⁵ *Commissioner of Inland Revenue v Canterbury Frozen Meat Co Ltd* [1994] 2 NZLR 681 (CA).

³⁶ *Commissioner of Inland Revenue v Lemmington Holdings Ltd* [1982] 1 NZLR 517 (CA) and *Miller v Commissioner of Inland Revenue* [1995] 3 NZLR 664 (CA).

³⁷ *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 at [18] (PC).

³⁸ *Commissioner of Taxation v Futuris Corporation Ltd* (2008) 247 ALR 605 (HCA).

some extent, run together, with both seen as not producing an assessment that is immune from judicial review.

In the past, taxpayers going down the judicial review route have often sought to delay the statutory processes (whether prior to or after assessment) until the judicial review proceedings are completed; this on the ostensibly sensible ground that before this point it would be premature to proceed with the statutory process. The potential for delay is obvious. As well, collateral challenge diverts effort and resources from what might be thought to be the more important task of determining the correct tax position of the taxpayer.

V OTHER CONTEXTUAL FACTORS

Contextual but nonetheless very important practical features of the tax disputes process are use of money charges and penalties. These make unsuccessful tax litigation an expensive exercise for a taxpayer, and this necessarily provides incentives which encourage settlement.

This is illustrated by what happened in the *Trinity* litigation.³⁹ The settlement terms reached by the investors who settled with the Commissioner on the eve of trial⁴⁰ produced a result for them which is in marked contrast to the consequences for the investors who litigated the case as far as the Supreme Court. Another relevant contextual factor is the 1996 establishment by the Inland Revenue Department of a litigation management unit. I suspect that this has resulted in a more structured and systematic approach by the Department to the management of complex tax disputes.

VI JUDICIAL INVOLVEMENT IN TAX DISPUTES – MORE ABOUT PROCESS THAN SUBSTANCE

A The mix of cases

Tax litigation is frequently about process. Mark Keating's recent review of the number and type of reported tax cases over the past three years yielded the following findings:⁴¹

From 2005 to the present, there was a total of 121 reported cases on procedural issues in the High Court, Court of Appeal and Supreme Court, while over that period there were only 27 purely substantive cases. Over that same period, the Taxation Review Authority (TRA) has determined 23 procedural cases compared with 29 substantive cases.

The distinction between process and substance can be slippery, because often enough determination of a procedural issue effectively resolves the case.⁴² That said, Mr Keating's observations accord with my own experience. In the five years during which I have been a member of the Court of Appeal, most of the tax cases I have sat on have been procedural in nature.

³⁹ This litigation recently culminated in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115.

⁴⁰ These are set out in *Accent Management Ltd v Commissioner of Inland Revenue* (2007) 23 NZTC 21,366 at [7] (CA).

⁴¹ See n 23 at 428.

⁴² As in *Allen v Commissioner of Inland Revenue* [2006] 2 NZLR 1 (SC).

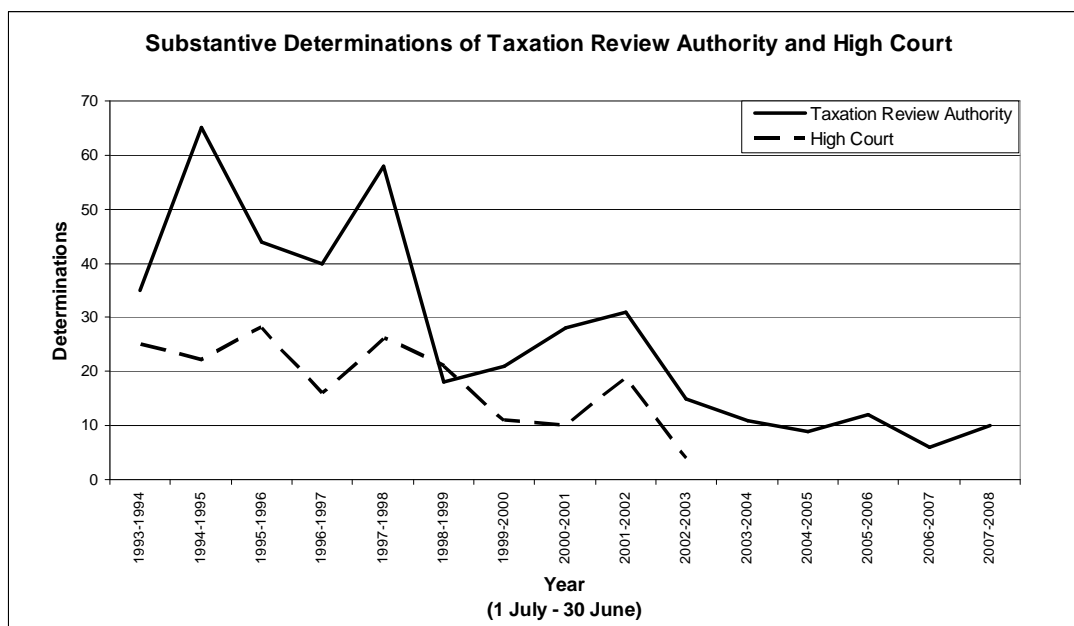
It is not entirely easy to assemble statistics as to the numbers of tax disputes that are resolved substantively by judicial determination. These figures, which once appeared in Inland Revenue Department annual reports, are apparently no longer collected. The best that I can offer is the following information which my clerk Peter Marshall was able to compile from various sources:⁴³

Table 1: Number of Tax Disputes: TRA and High Court

	Taxation Review Authority	High Court
1993-1994	35	25
1994-1995	65	22
1995-1996	44	28
1996-1997	40	16
1997-1998	58	26
1998-1999	18	21
1999-2000	21	11
2000-2001	28	10
2001-2002	31	19
2002-2003	15	4
2003-2004	11	
2004-2005	9	
2005-2006	12	
2006-2007	6	
2007-2008	10	

As far as I can tell, between 1996 and 2006 only 6 cases were determined by the Taxation Review Authority in its small claims jurisdiction. It appears that subsequently one more case has been determined in this way. The sharp decline in substantive determinations is perhaps best portrayed graphically:

⁴³ Up to 2002-2003 the data was sourced either directly from the Department or from its annual reports. After this, the data was compiled manually from the archives of the Ministry of Justice's Tribunals Unit: a substantive determination was defined to exclude interlocutory rulings (except successful strike out applications that substantively disposed of the case) and interim decisions. Figures for the High Court after 2002-2003 were not available.



B Why so many procedural cases?

I think it unsurprising that there have been, and continue to be, so many procedural disputes. The new procedures as introduced in 1996 differed significantly from what had gone before. Some teething difficulties were thus inevitable. More importantly, however, there are some design features and flaws of the scheme that encourage dispute.

To my way of thinking, one significant flaw is that the new provisions did not fit altogether easily with other, unamended, provisions of the Tax Administration Act. For instance, prior to the 2004 amendments, s 113 provided simply:

113 Commissioner may at any time amend assessments

(1) The Commissioner may from time to time, and at any time, make all such alterations in or additions to an assessment as the Commissioner thinks necessary in order to ensure its correctness, notwithstanding that tax already assessed may have been paid.

(2) If any such alteration or addition has the effect of imposing any fresh liability or increasing any existing liability, notice of it shall be given by the Commissioner to the taxpayer affected.

Although some attempts have been made to tidy up the incongruities (for instance s 89N has been introduced and s 113 is now expressed to be subject to it), there remain loose ends as to the consequences, if any, of deviations by the Commissioner from the scheme of Part 4A and also as to the impact of the evidence exclusion rule.

Importantly, s 114(a) prevents any assessment being challenged on grounds of non-compliance with procedural requirements. This section has not been amended and it remains to be seen whether it will provide a safe long stop for the Commissioner in the event of established non-compliance with Part 4A. It probably will do so with breaches of s 89C as the legislation contemplates that an

assessment issued in breach of s 89C is nonetheless valid.⁴⁴ Reliance on s 114, however, arguably will not save an assessment issued in breach of s 89N given the peremptory language used and the amendment to s 113. If so, this may prove a little awkward as some of the exceptions listed in s 89N(1)(c) involve questions of degree⁴⁵ and there may be legitimate scope for disagreement as to whether they have been properly invoked. The possibility that truncating the process may result in the invalidity of an assessment could deter the Commissioner from invoking these exceptions. And where such an exception is invoked by the Commissioner, the possibility of securing a technical knock out will encourage the taxpayer to challenge the process.

So, to some (but an uncertain) extent, the legislative provisions in Part 4A are directory⁴⁶ in character and the incoherent structure of the legislation invites litigation.

The evidence exclusion rule applies not only to “evidence” but also to legal propositions. What is not clear from the statute as it now stands is the impact of the evidence exclusion rule on the s 138P entitlement of a hearing authority (whether Taxation Review Authority or High Court) to exercise the powers of the Commissioner. Is it possible for a hearing authority to decide a case on the basis of a legal proposition not advanced in the SOPs? If the disclosure notice/SOP procedure had been invoked in the Trinity case, it is almost inconceivable that the Commissioner would have been bold enough to advance the legal proposition that s BG 1 of the Income Tax Act 1994 means what it says. Yet, on perhaps a simplistic analysis, this is pretty much what a majority in the Supreme Court concluded.⁴⁷ Would the majority have been debarred from deciding the case on that basis if the evidence exclusion rule applied?

A related problem is the new disputes resolution process has always only been partially implemented by legislation. The Organisational Review Committee envisaged that:⁴⁸

The audit investigation and final quantification of liability should, as far as practicable, be clearly separated.

This, however, is only currently provided for at the adjudication step in the process, which is not legislatively required. While the courts do not hold the Commissioner to administrative procedures laid down in the relevant policy statements, inconsistency between policy statements and the Commissioner’s actions has proved to be a common trigger for litigation.

This last point raises an issue as to the design of the legislation. Pre-assessment procedures involving more elaborate debate between Commissioner and taxpayer (including provision for NOPAs, NORs, conferences and reference to the Adjudication Unit) could have been introduced administratively. If that approach had been adopted, the need for legislative amendment would have been limited – confined probably to the establishment of an evidence exclusion rule (if thought appropriate) and a small claims procedure.

⁴⁴ See s 89D(b) and *Spencer v Commissioner of Inland Revenue* (2004) 21 NZTC 18,818 (HC) at [50].

⁴⁵ See for example s 89N(1)(c)(ii) and (iii).

⁴⁶ Not a very good word, I know, but it captures the idea that non-compliance might not matter.

⁴⁷ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115.

⁴⁸ Organisational Review Committee *Organisational Review of the Inland Revenue Department*, (Wellington, April 1994) at 67.

Alternatively, the dispute resolution process could have been legislated for comprehensively. What has happened, however, is that a system of dispute resolution which was presumably originally designed as a single comprehensive system, is now implemented partly by statute and partly as a matter of administrative practice. I suspect that whoever drafted s 89N (and in particular came up with the heading “completing the disputes process”) had in mind the disputes process as a whole (including the administrative steps of conference and adjudication). As it is, however, the section ends up, rather lamely to my way of thinking, with simply requiring the Commissioner to “consider” the taxpayer’s statement of position. Incoherence of this nature breeds disputes.

C Why so few substantive judicial determinations?

In the five years from 1993 to 1998, the Taxation Review Authority issued an average of 48.4 substantive determinations per year, whereas in the last five completed years this figure has plummeted to 9.6, a drop of over 80 percent. Equivalent figures are not available for substantive High Court determinations over the past five years. Despite this, given the way the annual number of High Court determinations has closely mirrored those of the Taxation Review Authority,⁴⁹ it is reasonable to assume that a corresponding decline has occurred in relation to High Court determinations.⁵⁰

The Inland Revenue Department’s 2003 discussion paper noted a sharp reduction in the number of litigated tax cases and commented:⁵¹

The current process would appear to a significant extent to be meeting its objectives because the number of audited cases that are disputed is decreasing and the cases that are being litigated are also decreasing.

The same paper noted that it is generally the higher value cases which are being litigated and that the Commissioner is becoming increasingly more successful in cases which are litigated.

The pre-assessment dispute process has presumably improved the accuracy of the assessment process. If so, this could be expected to have reduced the number of assessments that are properly open to dispute and correspondingly the number of disputes resulting in judicial determination. In particular, the adjudication process has involved administrative and pre-assessment determination of what would otherwise have been litigated disputes. It is also plausible to assume that the more robust the pre-assessment process, the more successful the Commissioner will be in the cases which do go to trial. So to some extent the comment in the discussion paper is probably right. I nonetheless see it as probably an incomplete explanation for what has happened. Other relevant factors presumably are:

Litigation risks associated with use of money charges and penalties that may serve to deter challenge proceedings.

The Commissioner’s ability to settle cases on a commercial basis.

⁴⁹ See the graph at p 9, above.

⁵⁰ This also accords with Keating’s figures, quoted above at p 8, in which he identified only 27 reported substantive tax determinations in the High Court over the period 2005-2008.

⁵¹ Inland Revenue Department *Resolving Tax Disputes: A Legislative Review* (Wellington, July 2003) at [1.7].

I see grounds for concern in the limited number of cases that are determined substantively by the courts. It means that taxation disputes are being largely resolved within the Inland Revenue Department. Because internal departmental opinions are necessarily backwards looking and controlled by the existing patterns of judicial decisions, there is little scope for judicial development of the law – the sort of fresh look exemplified by the Supreme Court judgment in the Trinity case. Associated with all of this is the possibility that some (and perhaps many) taxpayers are burnt off by the costs of the process and by the risks of litigation. The resulting practical unavailability of departmental opinions may be unhealthy in a society that subscribes to the rule of law.

VII POSSIBLE OUTCOMES

A number of possible reforms to the pre-assessment process have been promoted. The August 2008 Joint Submission made by the taxation committee of the New Zealand Law Society and the national tax committee of the New Zealand Institute of Chartered Accountants addressing Parts 4A and 8A of the Tax Administration Act suggested:

- More focused, coherent and clear NOPAs;
- Independent review of NOPAs and NORs within the Inland Revenue Department prior to the adjudication phase;
- A compulsory conference system;
- A softening of the use of money interest regime;
- A limiting of the evidence exclusion rule so that it applies only to propositions of law not advanced in the relevant statements of position;
- More symmetry in terms of time frames and sanctions as between Commissioner and taxpayer;
- Permitting the Adjudication Unit to make factual determinations; and
- A more coherent approach within the Department to the settlement of tax disputes.

Reforms suggested by commentators include compulsory mediation,⁵² entitlement for taxpayers to go straight to challenge proceedings after the exchange of NOPAs and NORs⁵³ and complete abolition of the evidence exclusion rule.⁵⁴

As a Judge, I perhaps have a bias towards judicial – over administrative – determination. And I have a very particular perspective which is necessarily associated with the sort of tax cases which reach the Court of Appeal – cases where it was reasonably clear from the outset that there would be litigation. For cases of that type (ie where litigation is practically inevitable) I think it clear the pre-assessment disputes procedures are unnecessarily complex, repetitive and time consuming (not to mention expensive for participants). Judges are well used to disclosure (in the context of discovery rules), pleading requirements and the circumstances in which amendment of pleadings is appropriate. Building functionally similar procedures into the pre-assessment stage of a tax dispute necessarily involves duplication of what is to follow if there is litigation.

⁵² See n 23 at 454.

⁵³ See J Coleman “Tax Update” [2007] *New Zealand Law Journal* 407 at 407 and see n 1 at 438.

⁵⁴ See n 53, at 408 and see n 1 at 438 and 439.

Importantly, the Commissioner, as a player/referee, is not well placed to manage such processes. The recommendations of the Organisational Review Committee came at a time when case management in the High Court was a comparatively recent innovation. My reading of the report suggests that the Committee saw the timetabling of litigation as the primary benefit of “judicial management” and in this respect may have underestimated the ability of the Court system to manage disputes in an effective and fair manner.⁵⁵

As an appellate Judge I also have a preference for accurate factual and legal determinations unstructured by artificial constraints. Although I have not yet been required to deal with cases in which the evidence exclusion rule has had a role to play, I suspect that it will become extremely cumbersome in practice, with arguments of a “how long is piece of string character” as to its application and perhaps forced resort to either the exceptions (which are not well addressed to the exigencies of the resolution of complex disputes) or perhaps s 138P. Fear of falling foul of the evidence exclusion rule encourages prolixity in SOPs. Because the evidence exclusion rule promotes reference to every conceivable argument that might be deployed, it has the perverse tendency to obscure rather than to elucidate what is truly in issue.

Further, I have a distinct preference for procedures that facilitate the resolution of substantive disputes rather than proliferate process disputes. As I have endeavoured to explain, the design of the dispute resolution process made procedural disputes inevitable.

I do not think that the answer lies in more add-ons to a process, which is already sufficiently complex. Indeed, it might be simpler and more effective to strip the required statutory process back to the bare essentials of assessment and challenge, and leave everything else to departmental practice, with the Commissioner and taxpayer free to engage in elaborate pre-assessment exchanges if they choose. This would reduce the expense and time associated with tax disputes although it would presumably also result in less accuracy in the assessment process.

I have been at pains to recognise the limitations of my perspective and I accept that the tax system cannot be designed around the comparatively few tax disputes that go to court. That said, the issue whether the whole process has become too hard and too expensive for taxpayers warrants consideration as part of a fresh look at the system, incorporating not only the process perspective of the Inland Revenue Department and the practical requirements of tax advisers and taxpayers but also rule of law principles.

⁵⁵ See g Blanchard “The Case For A Simplified Tax Disputes Process”, (2005) 11 *New Zealand Journal of Taxation Law and Policy* 417 at 437.

APPENDIX

Relevant Sections of the Tax Administration Act 1994

6 Responsibility on Ministers and officials to protect integrity of tax system

- (1) Every Minister and every officer of any government agency having responsibilities under this Act or any other Act in relation to the collection of taxes and other functions under the Inland Revenue Acts are at all times to use their best endeavours to protect the integrity of the tax system.
- (2) Without limiting its meaning, **the integrity of the tax system** includes—
 - (a) Taxpayer perceptions of that integrity; and
 - (b) The rights of taxpayers to have their liability determined fairly, impartially, and according to law; and
 - (c) The rights of taxpayers to have their individual affairs kept confidential and treated with no greater or lesser favour than the tax affairs of other taxpayers; and
 - (d) The responsibilities of taxpayers to comply with the law; and
 - (e) The responsibilities of those administering the law to maintain the confidentiality of the affairs of taxpayers; and
 - (f) The responsibilities of those administering the law to do so fairly, impartially, and according to law.

Compare: 1974 No 133 s 4(1)

6A Commissioner of Inland Revenue

- (1) The person appointed as chief executive of the Department under the State Sector Act 1988 is designated the Commissioner of Inland Revenue.
- (2) The Commissioner is charged with the care and management of the taxes covered by the Inland Revenue Acts and with such other functions as may be conferred on the Commissioner.
- (3) In collecting the taxes committed to the Commissioner's charge, and notwithstanding anything in the Inland Revenue Acts, it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law having regard to—
 - (a) The resources available to the Commissioner; and
 - (b) The importance of promoting compliance, especially voluntary compliance, by all taxpayers with the Inland Revenue Acts; and
 - (c) The compliance costs incurred by taxpayers.

89A Purpose of this Part

- (1) The purpose of this Part is to establish procedures that will—
 - (a) Improve the accuracy of disputable decisions made by the Commissioner under certain of the Inland Revenue Acts; and
 - (b) Reduce the likelihood of disputes arising between the Commissioner and taxpayers by encouraging open and full communication—
 - (i) To the Commissioner, of all information necessary for making accurate disputable decisions; and
 - (ii) To the taxpayers, of the basis for disputable decisions to be made by the Commissioner; and
 - (c) Promote the early identification of the basis for any dispute concerning a disputable decision; and
 - (d) Promote the prompt and efficient resolution of any dispute concerning a disputable decision by requiring the issues and evidence to be considered by the Commissioner and a disputant before the disputant commences proceedings.
- (2) This Part does not apply with respect to any tax returns or notices of assessments that are, or become, subject to objection proceedings under Part 8.
- (3) Despite section 1(2), this Part applies to disputable decisions made by the Commissioner for tax years before the 1994-95 tax year.

89C Notices of proposed adjustment required to be issued by Commissioner

The Commissioner must issue a notice of proposed adjustment before the Commissioner makes an assessment, unless—

- (a) The assessment corresponds with a tax return that has been provided by the taxpayer; or
- (b) The taxpayer has provided a tax return which, in the Commissioner's opinion, appears to contain a simple or obvious mistake or oversight, and the assessment merely corrects the mistake or oversight; or
- (c) The assessment corrects a tax position previously taken by the taxpayer in a way or manner agreed by the Commissioner and the taxpayer; or
- (d) The assessment reflects an agreement reached between the Commissioner and the taxpayer; or
- (db) the assessment is made in relation to a matter for which the material facts and relevant law are identical to those for an assessment of the taxpayer for another period that is at the time the subject of court proceedings; or
- (e) The Commissioner has reasonable grounds to believe a notice may cause the taxpayer or an associated person—

- (i) To leave New Zealand; or
 - (ii) To take steps, in relation to the existence or location of the taxpayer's assets, making it harder for the Commissioner to collect the tax from the taxpayer; or
- (eb) the Commissioner has reasonable grounds to believe that the taxpayer has ... been involved in fraudulent activity; or
- (f) The assessment corrects a tax position previously taken by a taxpayer that, in the opinion of the Commissioner is, or is the result of, a vexatious or frivolous act of, or vexatious or frivolous failure to act by, the taxpayer; or
- (g) The assessment is made as a result of a direction or determination of a court or the Taxation Review Authority; or
- (h) The taxpayer has not provided a tax return when and as required by a tax law; or
- (i) the assessment is made following the failure by a taxpayer to withhold or deduct an amount required to be withheld or deducted by a tax law or to account for an amount withheld or deducted in the manner required by a tax law; or
- (j) The taxpayer is entitled to issue a notice of proposed adjustment in respect of a tax return provided by the taxpayer, and has done so; or
- (k) The assessment corrects a tax position taken by the taxpayer or an associated person as a consequence or result of an incorrect tax position taken by another taxpayer, and, at the time the Commissioner makes the assessment, the Commissioner has made, or is able to make, an assessment for that other taxpayer for the correct amount of tax payable by that other taxpayer; or
- (l) The assessment results from an income statement under Part 3A; or
- (m) the assessment includes a calculation by the Commissioner of a tax credit identified in subparts MA to MF and MZ of the Income Tax Act 2007.

89D Taxpayers and others with standing may issue notices of proposed adjustment

- (1) If the Commissioner—
- (a) Issues a notice of assessment to a taxpayer; and
 - (b) Has not previously issued a notice of proposed adjustment to the taxpayer in respect of the assessment, whether or not in breach of section 89C,—

the taxpayer may, subject to subsection (2), issue a notice of proposed adjustment in respect of the assessment.

- (2) A taxpayer who has not furnished a return of income for an assessment period may dispute the assessment made by the Commissioner only by furnishing a return of income for the assessment period.
- (2A) For the purpose of subsection (2), section 33(2) does not apply.

- (2B) A taxpayer to whom section 80F applies who has not furnished an amended income statement for an assessment period may dispute a deemed assessment under section 80H only by furnishing an amended income statement for the assessment period.
- (2C) A taxpayer who has not provided a GST tax return for a GST return period may not dispute the assessment made by the Commissioner other than by providing a GST return for the GST return period.
- (2D) For the purpose of subsection (2C), [section 16(6)] of the Goods and Services Tax Act 1985 does not apply.
- (3) If the Commissioner—
- (a) Issues a notice of disputable decision that is not a notice of assessment; and
 - (b) The notice of disputable decision affects the taxpayer,—

the taxpayer, or any other person who has the standing under a tax law to do so on behalf of the taxpayer, may issue a notice of proposed adjustment in respect of the disputable decision.

(4) *Repealed.*

- (5) For a notice of proposed adjustment issued under this section to have effect, the notice must be issued within the applicable response period.

89E Election of small claims jurisdiction of Taxation Review Authority

- (1) Where a disputant—
- (a) Issues a notice of proposed adjustment under section 89D or 89DA and the amount in dispute is \$30,000 or less; or
 - (b) Rejects a notice of proposed adjustment issued by the Commissioner under section 89B and the amount in dispute is \$30,000 or less,—

the disputant may elect, in the disputant's notice of proposed adjustment or notice of rejection, that any unresolved dispute arising from the notice of proposed adjustment is to be heard by a Taxation Review Authority acting in its small claims jurisdiction.

- (2) If a disputant elects under subsection (1) to challenge a disputable decision or tax liability in a Taxation Review Authority acting in its small claims jurisdiction, the decision is irrevocable and binds the disputant.

89G Issue of response notice

- (1) To reject a proposed adjustment, the recipient of the notice of proposed adjustment must, within the response period for the notice, notify the issuer that the adjustment is rejected by issuing a response notice.
- (2) A notice of response must state concisely—
- (a) the facts or legal arguments in the notice of proposed adjustment that the issuer of the notice of response considers are wrong; and

- (b) why the issuer of the notice of response considers those facts or legal arguments to be wrong; and
- (c) any facts and legal arguments relied on by the issuer of the notice of response; and
- (d) how the legal arguments apply to the facts; and
- (e) the quantitative adjustments to any figure referred to in the notice of proposed adjustment that result from the facts and legal arguments relied on by the issuer of the notice of response.

89H Deemed acceptance

- (1) If a disputant does not, within the response period for a notice of proposed adjustment issued by the Commissioner, reject an adjustment contained in the notice, the disputant is deemed to accept the proposed adjustment and section 89I applies.
- (2) If the Commissioner does not, within the response period for a notice of proposed adjustment issued by a disputant, reject an adjustment contained in the notice, the Commissioner is deemed to accept the proposed adjustment and section 89J applies.
- (3) Where—
 - (a) A disputant does not, within the response period for replying to a notice from the Commissioner rejecting an adjustment proposed by the disputant, reject in writing all or part of the Commissioner's notice, the disputant is deemed to accept the matters specified in the Commissioner's notice; or
 - (b) The disputant accepts all or part of the Commissioner's notice in writing,—

then, in those circumstances,—

- (c) Section 89I applies as if the matters contained in the Commissioner's notice were an adjustment or adjustments proposed by the Commissioner; and
- (d) The Commissioner's notice is deemed, for the purposes of section 89K, to be a notice of proposed adjustment.

89M Disclosure notices

- (1) Unless subsection (2) applies, and subject to section 89N, the Commissioner must issue a disclosure notice in respect of a notice of proposed adjustment to a disputant at the time or after the Commissioner or the taxpayer, as the case may be, issues the notice of proposed adjustment.
- (2) The Commissioner may not issue a disclosure notice in respect of a notice of proposed adjustment if the Commissioner has already issued a notice of disputable decision that includes, or takes account of, the adjustment proposed in the notice of proposed adjustment.
- (3) Unless the disputant has issued a notice of proposed adjustment, the Commissioner must, when issuing a disclosure notice,—

- (a) Provide the disputant with the Commissioner's statement of position; and
- (b) Include in the disclosure notice—
 - (i) A reference to section 138G; and
 - (ii) A statement as to the effect of the evidence exclusion rule.
- (4) The Commissioner's statement of position in the prescribed form must, with sufficient detail to fairly inform the disputant,—
 - (a) Give an outline of the facts on which the Commissioner intends to rely; and
 - (b) Give an outline of the evidence on which the Commissioner intends to rely; and
 - (c) Give an outline of the issues that the Commissioner considers will arise; and
 - (d) Specify the propositions of law on which the Commissioner intends to rely.
- (5) If the Commissioner issues a disclosure notice to a disputant, the disputant must issue the Commissioner with the disputant's statement of position within the response period for the disclosure notice.
- (6) A disputant's statement of position in the prescribed form must, with sufficient detail to fairly inform the Commissioner,—
 - (a) Give an outline of the facts on which the disputant intends to rely; and
 - (b) Give an outline of the evidence on which the disputant intends to rely; and
 - (c) Give an outline of the issues that the disputant considers will arise; and
 - (d) Specify the propositions of law on which the disputant intends to rely.
- (6B) In subsections (4)(b) and (6)(b), **evidence** refers to the available documentary evidence on which the person intends to rely, but does not include a list of potential witnesses, whether or not identified by name.
- (7) A disputant who does not issue a statement of position in the prescribed form within the response period for the statement of position, is treated as follows:
 - (a) if the Commissioner has proposed the adjustment to the assessment, the disputant is treated as having accepted the Commissioner's notice of proposed adjustment or statement of position:
 - (b) if the disputant has proposed the adjustment to the assessment, the disputant is treated as not having issued a notice of proposed adjustment.
- (8) The Commissioner—
 - (a) May, within the response period for a disputant's statement of position, provide the disputant with additional information in response to the disputant's statement of position; and

- (b) Must provide the additional information as far as possible in the manner required by subsection (4).
- (9) The additional information provided by the Commissioner under subsection (8) is deemed to form part of the Commissioner's statement of position.
- (10) The Commissioner may apply to the High Court for more time to reply to a disputant's statement of position if—
 - (a) The Commissioner applies before the expiry of the response period for the disputant's statement of position; and
 - (b) The Commissioner considers it is unreasonable to reply to the disputant's statement of position within the response period, because of the number or complexity or novelty of matters raised in the disputant's statement of position.
- (11) The disputant may apply to the High Court for more time within which to reply to the Commissioner's statement of position if—
 - (a) The disputant applies before the expiry of the response period for the Commissioner's statement of position; and
 - (b) The disputant considers it unreasonable to reply to the Commissioner's statement of position within the response period, because the issues in dispute had not previously been discussed between the Commissioner and the disputant.
- (12) The High Court shall, in considering an application under subsection (11), have regard to the provisions of section 89A and the conduct of the parties to the dispute.
- (13) The Commissioner and a disputant may agree to additional information being added, at any time, to either of their statements of position.
- (14) The additional information provided by the Commissioner or a disputant under subsection (13) is deemed to form part of the provider's statement of position.

89N Completing the disputes process

- (1) This section applies if—
 - (a) a notice of proposed adjustment has been issued; and
 - (b) the dispute has not been resolved by agreement between the Commissioner and the disputant; and
 - (c) none of the following applies:
 - (i) the Commissioner notifies the disputant that, in the Commissioner's opinion, the disputant in the course of the dispute has committed an offence under an Inland Revenue Act that has had an effect of delaying the completion of the disputes process:
 - (ii) the Commissioner has reasonable grounds to believe that the disputant

may take steps in relation to the existence or location of the disputant's assets to avoid or delay the collection of tax from the disputant:

- (iii) the Commissioner has reasonable grounds to believe that a person who is, under the 1988 version provisions in subpart YB of the Income Tax Act 2007, an associated person of the disputant may take steps in relation to the existence or location of the disputant's assets to avoid or delay the collection of tax from the disputant:
 - (iv) the disputant has begun judicial review proceedings in relation to the dispute:
 - (v) a person who is, under the 1988 version provisions in subpart YB of the Income Tax Act 2007, an associated person of the disputant and is involved in another dispute with the Commissioner involving similar issues has begun judicial review proceedings in relation to the other dispute:
 - (vi) during the disputes process, the disputant receives from the Commissioner a requirement under a statute to produce information relating to the dispute and fails to comply with the requirement within a period that is specified in the requirement:
 - (vii) the disputant elects under section 89E to have the dispute heard by a Taxation Review Authority acting in its small claims jurisdiction:
 - (viii) the disputant and the Commissioner agree in writing that they have reached a position in which the dispute would be resolved more efficiently by being submitted to the court or Taxation Review Authority without completion of the disputes process:
 - (ix) the disputant and the Commissioner agree in writing to suspend proceedings in the dispute pending a decision in a test case referred to in section 89O.
- (2) If this section applies, the Commissioner may not amend an assessment under section 113 before one of the following occurs:
- (a) the Commissioner or the disputant accepts a notice of proposed adjustment, notice of response, or statement of position issued by the other:
 - (b) the Commissioner considers a statement of position issued by the disputant.
- (3) Despite subsection (2), the Commissioner may apply to the High Court for an order that allows more time for the completion of the disputes process, or for an order that completion of the disputes process is not required.
- (4) The Commissioner must make an application under subsection (3) within the period of time during which the Commissioner would otherwise be required, under the Inland Revenue Acts, to make an amended assessment.
- (5) If the Commissioner makes an application under subsection (3), the Commissioner must make an amended assessment by the last day of the period that—

- (a) begins on the day following the day by which the Commissioner, in the absence of the suspension, would be required under the Inland Revenue Acts to make the amended assessment; and
- (b) contains the total of—
 - (i) the number of days between the date on which the Commissioner files the application in the High Court and the earliest date on which the application is decided by the High Court or the application or dispute is resolved;
 - (ii) the number of days allowed by an order of a court as a result of the application.

109 Disputable decisions deemed correct except in proceedings

Except in objection proceedings under Part 8 or a challenge under Part 8A,—

- (a) No disputable decision may be disputed in a court or in any proceedings on any ground whatsoever; and
- (b) Every disputable decision and, where relevant, all of its particulars are deemed to be, and are to be taken as being, correct in all respects.

Compare: 1976 No 65 s 27

113 Commissioner may at any time amend assessments

- (1) Subject to sections 89N and 113D, the Commissioner may from time to time, and at any time, amend an assessment as the Commissioner thinks necessary in order to ensure its correctness, notwithstanding that tax already assessed may have been paid.
- (2) If any such amendment has the effect of imposing any fresh liability or increasing any existing liability, notice of it shall be given by the Commissioner to the taxpayer affected.

Compare: 1976 No 65 s 23

114 Validity of assessments

An assessment made by the Commissioner is not invalidated—

- (a) through a failure to comply with a provision of this Act or another Inland Revenue Act; or
- (b) because the assessment is made wholly or partially in compliance with—
 - (i) a direction or recommendation made by an authorised officer on matters relating to the assessment;
 - (ii) a current policy or practice approved by the Commissioner that is applicable to matters relating to the assessment.

138G Effect of disclosure notice: exclusion of evidence

(1) Unless subsection (2) applies, if the Commissioner issues a disclosure notice to a disputant, and the disputant challenges the disputable decision, the Commissioner and the disputant may raise in the challenge only—

- (a) The facts and evidence, and the issues arising from them; and
- (b) The propositions of law,—

that are disclosed in the Commissioner's statement of position and in the disputant's statement of position.

(2) A hearing authority may, on application by a party to a challenge to a disputable decision, allow the applicant to raise in the challenge new facts and evidence, and new propositions of law, and new issues, if satisfied that—

- (a) The applicant could not, at the time of delivery of the applicant's statement of position, have, with due diligence, discovered those facts or evidence; or discerned those propositions of law or issues; and
- (b) Having regard to the provisions of section 89A and the conduct of the parties, the hearing authority considers that the admission of those facts or evidence or the raising of those propositions of law or issues is necessary to avoid manifest injustice to the Commissioner or the disputant.

(3) For the purposes of subsection (1), a statement of position includes any additional information that the Commissioner and the disputant agree (under section 89M(13)) to add to the statement of position.

138P Powers of hearing authority

(1) On hearing a challenge, a hearing authority may—

- (a) Confirm or cancel or vary an assessment, or reduce the amount of an assessment, or increase the amount of an assessment to the extent to which the Commissioner was able to make an assessment of an increased amount at the time the Commissioner made the assessment to which the challenge relates; or
- (b) Make an assessment which the Commissioner was able to make at the time the Commissioner made the assessment to which the challenge relates, or direct the Commissioner to make such an assessment.

(1B) If a taxpayer brings a challenge and proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, a hearing authority must reduce the taxpayer's assessment by the specific amount.

(2) If the challenge relates to a disputable decision that is not an assessment, the hearing authority—

- (a) Must not make or alter the disputable decision; and
- (b) May direct the Commissioner to alter the disputable decision to the extent necessary to conform to the decision of the hearing authority with the effect the hearing authority specifies.

- (3) Subject to subsection (4), the Commissioner must make or amend an assessment or other disputable decision in such a way that it conforms to the hearing authority's determination.
- (4) The Commissioner is not required to make or amend an assessment or other disputable decision before the resolution of appeal procedures from the hearing authority.
- (5) The time bars in sections 108, 108A, and 108B do not apply with respect to—
 - (a) A determination of a hearing authority made under subsection (1)(a) or subsection (1B) of this section or an amendment made by the Commissioner to an assessment for the purpose of conforming to such a determination; or
 - (b) An assessment made by a hearing authority under subsection (1)(b) of this section or the Commissioner under subsection (3) of this section.

KEYNOTE ADDRESS

SUSTAINING GOOD PRACTICE TAX ADMINISTRATION

MICHAEL D'ASCENZO*

I INTRODUCTION

“Tax authorities already operate in an environment that is laden with risks.”¹ For the foreseeable future the spotlight on tax within a context of a global financial crisis, is set to hold special interest and new challenges for the ATO’s administration of Australia’s tax and superannuation systems. There are new laws which will need to be bedded down, for example the Taxation of Financial Arrangements, with its start date of 1 July 2009. The Government’s stimulus measures (as at 12 December 2008) include a range of tax measures such as:

- 10 percent temporary investment allowance to encourage capital investment by Australian businesses,²
- 20 percent cut in the next pay-as-you-go (PAYG) tax instalment for 1.3 million small businesses,³ and
- support for small businesses during the global financial crisis.⁴

The Henry Review of Taxation is in full consultation mode with the release of three papers last month.⁵ The Budget is also on the horizon, and the Government has foreshadowed changes to the pension system, and its intersection with taxation. This is occurring in the midst of a slowing economy, with associated tax risks.⁶

In this context of interesting times it is opportune to test assumptions about best practice tax administration. What does best practice mean in this new environment? This is particularly relevant to the ATO given its role to administer major aspects of Australia’s “tax-transfer system [which] is a fundamental part of Australia’s social and economic infrastructure”.⁷ It is also relevant as the ATO reviews its strategic statement for 2010-2015.

* Commissioner of Taxation.

¹ EDS, “The Extended Tax Authority”, 24 June 2008 p 15.

² Prime Minister of Australia, Media Release, “\$4.7 Billion Nation Building Package”, Issued 12 December 2008.

³ Ibid.

⁴ Prime Minister of Australia & Minister for Small Business, Joint Media Release, “Support for Small Business during Financial Crisis”, Issued 24 October 2008.

⁵ Australia’s future tax system: Consultation paper; Consultation paper summary; and Retirement Income Consultation paper, Commonwealth of Australia, December 2008.

⁶ See D’Ascenzo, M., “Playing it responsibly” Victorian Tax Bar Association 8 December 2008. But see more generally Weatherburn, D., “Economic Adversity and Crime” Australian Institute of Criminology, August 1992.

⁷ Australia’s future tax system, Consultation paper, Summary, December 2008, p 2.

II OVERVIEW OF TAX ADMINISTRATIONS

The OECD has just released the third edition of its comparative information series on aspects of tax administration in OECD and selected non-OECD countries.⁸ While great care needs to be taken in making comparisons of administrative features and performance across different countries, the OECD report provides a useful lens through which to assess good practice in tax administration.⁹

The OECD series presents a number of observations, which at their broadest level attest to the great variation between countries in their tax system administration. Institutional arrangements, organisational structures, governance frameworks, regimes for return filing, tax collection and assessment, and use of technology all exhibit significant differences across the countries studied.

The OECD is of the view that while comparison is useful, it needs to be conducted in full knowledge of the underlying key features of particular systems. Characteristics of a particular system cannot be viewed in isolation without appreciation for the ‘below the line’ arrangements that support them, and the environment in which they operate.

A Institutional arrangements and scope

Institutional arrangements are of course matters for Government and not for the administrations per se. Although there are quite marked differences in the institutional arrangements and levels of autonomy of tax authorities in OECD and non-OECD countries, it is still possible to identify trends and common characteristics.

The majority of the revenue bodies surveyed are unified semi-autonomous bodies that deliver both direct and indirect taxes.¹⁰ Australia and New Zealand both fit this model. The OECD notes that Australia has a unified semi-autonomous tax revenue body, sometimes known as the ‘executive agency’ model. Although drawing no firm conclusions, the report notes that there is a view that the executive agency model best promotes effectiveness and efficiency.¹¹

Even with its high levels of autonomy, the ATO operates within a framework of accountability to government and the community through a range of external and internal governance measures. External scrutiny includes appearances before the Joint Committee of Public Accounts and Audit and the Senate Economics Committee, and reviews by the Australian National Audit Office, the Inspector-General of Taxation and the Commonwealth Ombudsman among others.¹²

⁸ OECD, Forum on Tax Administration, “Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series”, 2008, (Note: due for publication in January 2009).

⁹ The ATO is also involved in a separate benchmarking study being conducted by McKinsey and Co for the OECD and another study in conjunction with the UK, the USA and South Africa.

¹⁰ OECD, above n 8, Draft Executive Summary, p 1.

¹¹ OECD, above n 8, Chapter 1, pp 9 – 11.

¹² The ATO welcomes external scrutiny, but it is resource intensive and does come at a cost. A conservative estimate of the cost of external scrutiny across the organisation is about 33 FTE or \$4,157,488 based on an average EL2.1 costing. And it is growing – In 2005 the ATO estimated 21 overall FTE, costed at \$2,451,235. For the most part these figures do not include the time of senior officers or the ongoing costs associated with the implementation of review recommendations and

Importantly, the Administrative Appeals Tribunal and the courts stand as final arbiters on the ATO's application of the laws it administers. Internal governance includes a comprehensive twice yearly plenary governance process, an audit committee with significant external representation, stringent quality assurance standards and an independent integrity adviser.

Australia's tax administration manages the income tax, GST and excise systems. In New Zealand, excise is administered by the customs body. There is no clear pattern in this arrangement across the broader set of countries studied.

The OECD notes there has been a general trend towards the increased use of the tax system (and by definition its tax administration arrangements) to deliver social and economic policies. The ATO delivers a range of personal and business benefits, for example, the private health insurance rebate, the superannuation co-contribution, the fuel credit scheme, and research and development subsidies. New Zealand's Inland Revenue follows this pattern and certainly based on resource usage, its role in these areas is very significant when contrasted with all other OECD countries.

The ATO also has a leading role in regulating the superannuation system, as does the NZ IRD with the 'KiwiSaver' scheme. However, unlike NZ IRD, the ATO no longer administers the Child Support Agency.

In some countries (for example, Denmark, Netherlands and Spain), tax administrations also have responsibility for customs administration.¹³ However, there is no trend in this direction and it is certainly not the practice in either Australia or New Zealand. If anything, and going on recent experience from Canada and the UK, the work of customs is increasingly being seen to be more in the domain of border security and is being aligned organisationally with related areas of government administration. Overall, this practice of giving revenue bodies additional non-tax functions represents a considerable ongoing challenge where revenue bodies are already contending with the growing complexity of tax systems, the globalisation of business and sometimes decreasing resources and budget.¹⁴

Most tax administrations are responsible for a 'mix' of activities, and there is a general shift in structural arrangements away from 'tax type' to 'function' or 'taxpayer segment' criteria.¹⁵ These are choices which are sometimes able to be made by the administrations. However, what the ATO has found is that major tax technical issues (for example, capital gains tax) cut across segments and therefore multiple lenses are often appropriate.

There is also duplication and inefficiencies in non-functional structures but failure to have integrated strategies, significantly reduces the effectiveness of the organisation. The ideal would be to garner potential efficiencies while retaining the external focus on taxpayers and on the effectiveness of holistic and flexible strategies. For example, in the ATO we are making progress with enterprise-wide approaches (where that makes sense) and retaining the differentiation implicit in

ongoing reporting. As well, the costs of parliamentary scrutiny (eg Senate Estimates and JCPAA) have not been included and nor has the time spent on briefings and discussions with ministers and scrutineers.

¹³ OECD, above n 8, Table 4 (Non-tax functions of revenue bodies), p 7.

¹⁴ OECD, above n 8, Draft Executive Summary, p 1.

¹⁵ OECD, above n 8, Draft Executive Summary, p 1.

our Compliance Model.¹⁶ Eliminating silo mentality wherever possible is critical to being responsive to challenges and opportunities. Structure should respond to strategy, not the other way around.

There is also an emerging trend towards creating specialist or dedicated operational units, such as national call centres and data processing centres, rationalising the size of office networks to deliver frontline tax administration operations.¹⁷ Nevertheless, the balance between back office and front line functions is difficult to set, particularly as new technology expands the remit of what is in essence front line work.

For example, the ATO's expanded use of data matching and pre-filling fits the descriptor of front line work. Moreover any tax administration that does not have an appropriate focus on enablers such as plan and manage, people and place and IT and change is not only unlikely to be sustainable but will also limit its effectiveness and efficiency.

B Legal and administrative frameworks

The report notes an increase over the past few years in the number of countries with a formal set of taxpayers' rights.¹⁸ The ATO's complaint management and alternative dispute resolution processes have been rated as best practice.¹⁹ Importantly, our professionalism surveys continue to show high levels of satisfaction across a range of measures including respect, courtesy and fairness.²⁰ Australia has recently celebrated the 10 year anniversary of its Taxpayers' Charter.

C Strategic management and transparency

Overall the OECD report notes arrangements in place that help to improve the accountability of revenue bodies, including the almost universal use of annual business plans and reports. However, there are some variations in levels of transparency.²¹

The preparation of multi-year business plans is almost universal. However, significantly fewer revenue bodies make such plans publicly available.²² The ATO publishes both a multi-year strategic statement and corporate plan and an annual compliance program besides its annual report on its performance.

The practice of setting formal service delivery standards is common around the world, however, the report notes that not all revenue authorities publish or publicly report on results against these survey standards.²³

¹⁶ ATO, Understanding and applying the compliance model, <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>

¹⁷ OECD, above n 8, Draft Executive Summary, p 1.

¹⁸ OECD, above n 8, Draft Executive Summary, p 2.

¹⁹ Commonwealth Ombudsman, Annual Report 2005-2006, p 62; and Bentley, D., "Taxpayers Rights: Theory, Origin and Implementation", *Kluwer Law International*, 2007, pp 178-212.

²⁰ ATO Annual Report, p 25.

²¹ OECD, above n 8, Draft Executive Summary, p 3.

²² OECD, above n 8, Chapter 3, p 39.

²³ OECD, above n 8, Chapter 3, p 39.

The ATO publishes these standards monthly. The ATO also measures our professionalism and has strong quality assurance processes. The results of both are made public, as are the results of our independently conducted surveys.²⁴

In terms of transparency, our flagship statistical publication, Taxation statistics (for 2006-2007) is due to be released in the next few months. Over the last few years we have invested significant time and resources in improving its usability and profile in the (research) community. This included the setting up of the Taxation Statistics Advisory Group which was established during 2006 to help manage the development and direction of this series of data.

A recent and important step forward for us has been the preparation of a 1 percent sample file of confidentialised individual tax return form records. A pilot sample file is currently being user-tested by external representatives from the Advisory Group. The pilot will be reviewed during the Group's February meeting and our ambition is to make the 2006-07 sample file available at the same time we release the Taxation statistics 2006-07 publication.

D Resources and costs of collection

In terms of relative staff numbers for tax administration, the ratios displayed for both the ATO and NZ IRD are almost identical (at around 1 staff member for every 520 labour force participants) and well ahead of most European countries where the numbers tend to range between 300-400. However, the fuller context needs to be recognised here—many European countries administer taxes that elsewhere are the domain of sub-national bodies (e.g. real property taxes).

The data presented also reveals a broadly decreasing trend in the cost of collection ratios (that is, the relationship between costs of administration and net revenue collected) across most countries over recent years.²⁵ This ratio and more importantly its trend are frequently used by revenue bodies as a crude measure of relative efficiency. However, given various 'design differences' comparisons need to be made with considerable care and used only as a pointer to further inquiry. In terms of effectiveness, the measure does not compensate for economies of scale nor the quantity and quality of services and activities.

The ATO's costs of collection have reduced from 1.06 percent in 2001 to 0.93 in 2007.²⁶ All things being equal, after the implementation of our change program we are planning to further reduce our costs of collections (and also to reduce compliance costs for taxpayers). In the case of NZ IRD, the figures are even more favourable (i.e. from 0.90 in 2001 to 0.75 in 2007) but are influenced in part by the higher legislated tax burden in NZ (approximately 20 percent higher). These are quite positive results for both bodies for the period under review. However, this ratio will inevitably be impacted in the medium term by the difficult economic conditions both countries are currently facing.

²⁴ See ATO, Our Research, http://www.ato.gov.au/corporate/pathway.asp?pc=001/001/024&mfp=001&mnu=39508#001_001_024.

²⁵ OECD, above n 8, Draft Executive Summary, p 1.

²⁶ OECD, above n 8, Table 11 (Comparison of aggregate administrative costs to net revenue collections/1), pp 19-20.

E Areas of operational performance

The OECD report notes that the incidence of overpaid taxes (which must be refunded to taxpayers) for many countries in aggregate terms is higher than perhaps generally recognised.²⁷ Roughly \$1 in every \$5 collected by the ATO is refunded to taxpayers.²⁸ This is higher than the ‘norm’ but largely reflects a range of factors that are external to the administration – policy design (eg GST exemption on exports and food, personal income tax withholding arrangements and work related expenses/deductions). The corresponding figure for NZ is roughly \$1 in every \$6. Such a high rate does, of course, raise compliance burden issues and the need for efficient refund mechanisms.²⁹

The report also looks at the collection of unpaid taxes. A key measure of effectiveness (and relative payment compliance) is the value of year-end tax debt to annual net revenue collected during the fiscal year.

In 2007, Australia’s and New Zealand’s ratio was, coincidentally, 4.3 percent and both appear to be trending downwards.³⁰ This ratio is well below the OECD norm, although above reported rates for a few other countries (e.g. Denmark and Ireland).³¹ Interestingly, the report observes that the following administrative ‘characteristics’ tend to be present in countries with very low levels of tax debts:

1. wide use of withholding
2. a very comprehensive set of enforced collections powers
3. a common penalty/interest framework across the major taxes
4. significant resource allocations for timely debt collection
5. fairly aggressive write off policies concerning uncollectible debt, and
6. use of direct debit collection capabilities.

The current global financial crisis may see a general increase in this or ratio for most tax administrations.

F Return filing, tax collection and assessment regimes

Withholding at source arrangements are generally regarded as the cornerstone of an effective income tax system.³² In this respect, the data in the report suggests that Australia, in comparison with most OECD countries, is a relatively ‘light’ user of withholding which is confined largely to employment income, investment income paid to non-residents, and as a sanction in the absence of TFN/ ABN quotation by taxpayers in particular situations. By way of comparison, NZ generally deducts tax at source on interest income and its withholding system extends to prescribed categories of contractors’ incomes.

An important feature of the personal tax systems in many countries is the operation of tax withholding arrangements (and other elements of tax law) that are designed to free the majority of employee taxpayers from the requirement to file

²⁷ OECD, above n 8, Chapter 5, p 66.

²⁸ OECD, above n 8, Chapter 5, p 67.

²⁹ But see, Joint Committee of Public Accounts and Audit “Report 410 – Tax Administration”, June 2008, pp 176-179, and 184-185.

³⁰ The ATO reduces this ratio by 4.02% in 2007-2008: ATO Annual Report 2007-08, p 3.

³¹ OECD, above n 8, Table 24 (Selected action concerning enforced tax collection activities), pp 40-41.

³² OECD, above n 8, Chapter 7, p 87.

an annual return – the ‘cumulative’ form of withholding for employment income, along with other complementary design features (eg strict limits on employees’ work-related deductions). However, these systems are not without their problems and tend to impose higher compliance costs on employers.³³

By way of contrast, Australia has a ‘non-cumulative’ withholding approach for employment income, requiring each taxpayer to file an annual tax return to assess their overall tax liability and to refund any amount overpaid. This is partly influenced by the availability of work related deductions and the intersection of the tax and transfer systems. Nevertheless the processing of tax returns is very automated, and its impact on taxpayers (particularly those with straight forward affairs) is being reduced significantly by initiatives such as e-tax, ‘electronic filing’ and, more recently, ‘pre-filing’.

Many countries support withholding regimes with mandatory reporting of third party information.³⁴ Significantly, the OECD series notes that most countries use ‘withholding at source’ arrangements for collecting personal income tax on employment income, and use withholding regimes for collection of income tax on interest and dividend income.³⁵ However, use of information reporting for small and medium enterprise taxpayers is much less developed although there are some noteworthy developments underway in the USA (e.g. reporting of prescribed business to business and government to business transactions).³⁶

III MEASURING THE EFFECTIVENESS OF THE ATO

Finding good measures of effectiveness is not easy and all performance indicators have their weaknesses and limitations. Nevertheless this is an important journey best illustrated by an example.

Registration is one of our ‘four pillars’ of ensuring compliance with the taxation and superannuation laws. The others are lodgment, correct reporting and correct payment.

Last year’s Annual Report provides information on our performance against service standards³⁷ and the number of registrations processed.³⁸ This is important but does it fully answer the key question of whether we have all the right people and businesses registered in the system? The answer is no.

When we start to look for indicators of our effectiveness, our starting point is to try and benchmark our performance against an external data set. In the case of registration for individuals, we can look to the Australian Bureau of Statistic’s data sets on population.

In 2008 there were 21.3 million Australian residents. At the same time the Tax Office had 17.7 million registered resident individuals. The simple comparison with the number of taxpayers registered in the tax system and the total number of Australian citizens suggests that 83 percent of the resident population have a tax file number.

³³ OECD, above n 8, Chapter 7, pp 88-89.

³⁴ OECD, above n 8, Chapter 7, p 92.

³⁵ OECD, above n 8, Draft Executive Summary, p 2.

³⁶ The US Internal Revenue Service (IRS) now also gets reports on credit card transactions and capital gains tax reports from brokerage firms. The ATO is discussing increased automatic exchanges of information with the IRS.

³⁷ ATO Annual Report, above n 30, pp 26-28.

³⁸ ATO Annual Report, above n 30, p 42.

However, this simple comparison is not the most useful given the differences in purposes of two data sets. Firstly, the ABS population estimates include those persons who have no need or obligation to register such as some children, students and pensioners. Secondly, the ABS estimate does not include non-residents while our tax file number data includes non-residents in receipt of Australian sourced income.

To account for these factors we make a comparison using the ABS population estimates for residents aged between 15 and 74 - focusing on the segment of the population that is more likely to have a need for a tax file number. We similarly align our registration counts by taking out those taxpayers who are under 15 or over 74 years of age. We also take out from our registration data set those taxpayers who are non-residents.

This leads to the following result. The ABS population reduces to 15.9 million residents aged between 15 and 74. Our adjusted registration data is 16.3 million registrations.

The resultant 103 percent comparison has decreased from 113 percent two years ago, reflecting some resource intensive work in removing non-active registrations. The result seemingly suggests high levels of compliance albeit that there may still be some taxpayers currently registered in the tax system who should not have an active registration.

However, a significant reason for the difference is that the tax file number data includes temporary residents while the ABS data does not. So a 103 percent comparison is an extremely good outcome.

Turning to businesses, there are difficulties in benchmarking against data from the Australian Bureau of Statistics because they use a different definition of business. There are further complications because the ABS data relies to some extent on our registration information.

So we have turned to some other benchmarks. The ratio of ATO company tax file number registrations to the Australian Security and Investment Commission companies registrations currently is 105 percent. When the ATO series is adjusted to account for those entities that do not need to register with ASIC, such as strata title companies and limited partnerships this ratio falls to 87 percent.

Again, like all indicators this indicator is far from perfect. For example there are some ASIC registered entities such as 'shelf companies' that do not have a current tax obligation. Nevertheless the results from these two measurement approaches provide a reasonable level of confidence in relation to our registration activities.

Registrations are perhaps one of the more straightforward areas for measuring our effectiveness and these two examples illustrate the challenges in developing better measures of effectiveness. Nevertheless, this work is fundamental to best practice tax administration.

A Tax gap measures

Tax gap measurement has its supporters,³⁹ however we note concerns about the accuracy of the estimates and the fact they may shed little light on the

³⁹ McManus, J. and Warren, N., "The Case for Measuring Tax Gap", (2006) 4(1) *e-Journal of Tax Research*, Volume 4, Number 1, August 2006.

sources of and reasons for non compliance.⁴⁰ If they involve “random audits” they are administratively expensive both in resource and opportunity costs, impose unnecessary compliance costs and can reduce community confidence. The Joint Committee of Public Accounts and Audit recently supported the ATO’s risk-based approach to compliance which minimises the burden on compliant taxpayers.⁴¹

As a new development we are undertaking some gap analysis for indirect taxes, relying on macro approaches such as those used in certain other jurisdictions, notably the UK. Here we are using ABS data together with GST expenditure information to support comparison of theoretical GST liability and actual GST outcomes. Our assumption is that the difference emerging could be viewed as the lost revenue or ‘gap’.

In relation to income tax, rather than impose additional burden arising from random audits on the generally compliant Australian taxpayer, we are looking at methods to extrapolate our active compliance (risk driven non-random based interventions) results across the broader community to obtain experimental estimates of potential reporting gaps. We also have ongoing work with Treasury and the Australian Bureau of Statistics to understand the relationship between independent measures of the economy with forecast and actual tax liabilities and collection, providing a platform for understanding apparent tax gaps. We will then be better placed to evaluate whether tax gap measurement of this type adds value to our current approaches to risk identification and assessment.⁴²

B *Micro measures*

To better evaluate our strategies, we have developed a methodology to help us measure how effective we have been in making positive and sustained changes to compliance behaviour and/or community confidence. This compliance effectiveness methodology has been published on our website together with a literature review. This methodology complements the practical application of the ATO’s Compliance Model.

Our methodology takes a bottom-up approach looking at discrete, compliance risks – but it is focused on outcomes rather than activities. It is relatively early days for this pioneering work. Nevertheless we are seeing added

⁴⁰ Note for example IRS Commissioner Douglas Shulman (21st Annual George Washington University International Tax Conference), IRS Newswire, IR-2008 – 137 of December 8, 2008: “Second is the international tax gap. So how big is it? It’s hard to say as I haven’t seen any solid research to arrive at conclusive numbers. Difficulties arriving at one include the complexity of cross-border audits, and the inherent complexity of the tax code in this area. But in some ways, whatever the size of the international tax gap, our commitment to this issue would be unchanged. That is because our international compliance efforts are much more about protecting the \$2.7 trillion base of revenue that we collect today rather than just the incremental enforcement revenue that we collect from these efforts”.

⁴¹ JCPAA “Report 410”, above n 29, p 127.

⁴² These current approaches include at the macro level – budget estimate forecasts, reviews of segments and industries against economic trends and expectations, environmental scan assessments, broad scale intelligence assessments, risk pool analysis, and health of the system assessments for each tax product - and at the micro level, transaction tolerances and risk-driven rules in our processing systems, external data matching activities, analytics-based case selection and targeted intelligence analysis of high risk areas.

discipline to the development and implementation of strategies to address high risk areas.

What we have learned from applying this discipline is that it encourages us to:

- define compliance behaviour and consider the drivers of that behaviour
- describe desired outcomes from the outset
- consult, collaborate and co-design with stakeholders relevant strategies
- design indicators that will enable us to assess the extent of the effectiveness of our strategies, and
- evaluate and refine our strategies in light of the outcome we want to demonstrate.

We now appreciate that our effectiveness is not demonstrated simply by evidence of the conduct of a range of compliance activities measured solely by cases completed and liabilities raised. We now also understand that effectiveness must be considered from the outset in the planning process.

For example, the ATO wanted to improve the lodgment performance of taxpayers with a balance of \$20,000 on their previous assessment. This population changes greatly from year to year with approximately 80 percent churn in the population. However, most of these taxpayers used a tax agent to manage their tax affairs. By understanding what we were trying to do and by understanding where we thought the key leverage point was, we developed with tax agents a strategy to achieve the desired outcome.

To date we have seen a marked improvement in on-time lodgment here, indicating that high value taxpayers and their agents have a greater and shared awareness of their responsibilities to lodge by the due date in accordance with the tax agents' lodgment program.⁴³ Our strategy appears to have also had a ripple effect to the broader tax agent community in terms of awareness of key priorities and responsibilities under a lodgment program designed jointly with tax agents.

C Making it easier, cheaper and more personalised

We publish a digest called "Making it easier to comply" which sets out our future intentions for improved products and services, and summarises how we have gone in meeting those intentions. We will shortly be publishing the latest update on our website.

D Improving ease of compliance

The taxpayer experience of dealing with the tax system is at the heart of good tax administration.⁴⁴ Citizens understandably expect interactions with government to be straightforward and efficient.

In the past few years we have been upgrading our systems with a view to making our interactions with taxpayers more personalised and streamlined. Progressively over the next few years, as people contact us by phone, letter, or in

⁴³ Developed jointly with the Lodgment Working Party - A subgroup of the ATO Tax Practitioner Forum.

⁴⁴ We have, for some time been trying to design services from the outside-in (that is taxpayer centred design) using the 3Cs (Consultation, Collaboration and Co-design) and our Simulation Centre. The objective is to minimise compliance costs for taxpayers and their agents.

person, we will have a complete online history of their dealings with us on the screen, including copies of correspondence.

We are currently creating a new IT environment for the organisation based on integrated and connected systems rather than a menu or separate systems. While this work is risky and ambitious, we are slowly getting closer to realising the goal of an integrated environment with its key benefits of significantly improving the taxpayer experience.⁴⁵

One of the upsides of breaking new ground is that we are changing ourselves and our business in the process. We recognise as an organisation that we need to continuously take new legislative requirements, government initiatives, community expectations and economic conditions and capability considerations into account as we plan for the future.

We also take a much more analytical approach to how people use our products and services and how satisfied they are with them. For example, in responding to feedback, our new auto call-back technology avoids the need for callers to have to wait online. We also recently delivered an improved website, complete with a superior search engine.⁴⁶

Similarly in responding to feedback, we now offer a wider range of convenient payment options both in Australia and overseas,⁴⁷ and are considering the feasibility of payment by credit card. In responding to the global financial crisis, taxpayers with a tax debt or unable to pay by the due date, can phone our automated self help service to set up a payment arrangement or make a late payment.⁴⁸ This service uses Natural Language Speech Recognition technology and operates 24 hours a day, seven days a week and reflects our community first approach to debt collection.

E Best Practice

Our change agenda is consistent with what is being recognised internationally as best practice⁴⁹ and includes:

- continuing to make tax returns for individuals easier by pre-populating the e-tax return with data from a growing range of third parties,
- helping business interact with us online, including simplifying the process for access to the business portal and developing more online tools and calculators that make it easier to work out obligations and entitlements,⁵⁰ and

⁴⁵ We had to reschedule our original change program plans to splice in the shifting sands of government policy including Super Simplification, and the First Home Saver's Account. This, and the complexity of the project have meant that delivery of some aspects of the largely self funded program have been delayed, deferring efficiency dividends and causing financial difficulties for the organisation.

⁴⁶ We are also exploring Web 2.0 technologies including wikis and blogs for internal and external consultation, collaboration or knowledge or ideas sharing.

⁴⁷ BPAY, Direct credit, Direct debit, Mail (Cheque/ Money order), Australia Post (Cash/ Cheque, EFTPOS, Overseas payments (BPAY, direct credit, mail).

⁴⁸ You can only use this phone service for debts that are less than \$25,000.

⁴⁹ "Many tax authorities recognise the need to work more outwardly and are beginning to focus their efforts on the systems, processes and data that sit outside their boundaries", EDS "The extended Tax Authority", (24 June 2008), p3.

⁵⁰ "The internet takes the edge of a tax system outside the physical confines of the Tax Office", EDS, above n 49, p 12.

- working with other government agencies to make business reporting to government simpler and easier.

More ‘joined up’ government⁵¹ is particularly relevant to the role of the Australian Business Registrar. Recent developments in relation to the Australian Business Register (ABR) include:

- improving governance – including greater involvement of partner agencies, and greater separation of ABR activities from ATO operations,
- conducting annual service reviews with partner agencies and more transparency and promotion of the ABR’s whole of government agenda, including a regular ABR Update newsletter,
- ongoing improvements to quality and data integrity, and
- on-going reductions in ineligible registrations.

In terms of more effective use of data, last year we used information on over 400 million transactions as part of our data matching and pre filling work. This included:

- 133 million security transactions from the Australian Securities Exchange and the major share registries
- 78 million transactions which were used to verify income and benefit information on individual tax returns
- 174 million transactions which were used to support other compliance activities; and
- 19.5 million property transactions and 3.5 million rental bond reports.

Our support of the Standard Business Reporting (SBR) initiative takes advantage of eXtensible Business Reporting Language (XBRL) and the ABR to reduce compliance costs for business.⁵² SBR is an example of expanding our horizon to support and integrate with taxpayer accounting and record keeping processes and with natural business systems and activities. Extending the horizon further includes consideration of point of transaction or event possibilities to make processes easier and in real time.

IV CONCLUSION

The ATO has developed “a positive reputation internationally”⁵³ and is known around the world as “one of the leading examples of best practice tax authorities”.⁵⁴ As we look into the foreseeable future, tax administrators will need to be even more careful in balancing the need to be fair, efficient and effective. On the one hand we must be vigilant for abusive tax practices so as to provide a level playing field, but at the same time empathetic to taxpayers facing real hardship.

In meeting this responsibility the ATO is well served by its corporate values of:

- Being fair and professional so as to give life to the Taxpayers’ Charter

⁵¹ Above n 49. “Similarly, many tax authorities have understood that delivering genuinely citizen-centric services also requires stepping outside their traditional boundaries by joining up services and data with other government departments, for example, through a single business registration function” EDS, above n 49, p 3.

⁵² Standard Business Reporting website, <http://www.sbr.gov.au/content/default.htm>.

⁵³ JCPAA, “Report 410”, above n 29, p 20.

⁵⁴ Inspector-General of Taxation quoted in JCPAA “Report 410”, above n 29, p 20.

- Applying the rule of law so that taxpayers' rights are respected and we distinguish Australia's administration from others which operate by fiat or which lack integrity
- Supporting taxpayers who want to do the right thing (putting ourselves in their shoes and treating them as we would expect to be treated in their circumstances). Being fair but firm with those that don't so as to deter non compliance, promote a level playing field and support honest taxpayers
- Being consultative, collaborative and willing to co-design to engage the community in the administration of their tax and superannuation systems and to reduce compliance costs
- Being open and accountable to foster community confidence and trust, and
- Being responsive to challenges and opportunities – so important in the current environment.

EUROPEAN TAXATION OF PASSIVE INCOME

MARCO GREGGI*

I INTRODUCTION

‘Europe is not a natural unity, like Australia or Africa; it’s the result of a long process of historical evolution and spiritual development’.¹ Prof. Dawson’s opinion, although developed in a historical perspective, could be easily extended even to law in general, and taxation law in particular, without losing anything of its value. More to the point, and under an economic perspective, the making of Europe was recently carried on in the interest of the Europeans but also taking into account the nearby countries and the more significant business partners all around the world. It wouldn’t be possible otherwise to explain EC Treaty articles, such as 56, which unilaterally attribute rights to third countries individuals and legal bodies.

EU law therefore is drafted according to this basic need as well: to create a political a legal unity open to the globalised economy and to the foreign capitals. According to this assumption, the evolution of the European legal system can be observed (particularly in a taxation perspective) from two different viewpoints: one internal and another one external. Under the first one, the evolution of EU law can be seen a struggle against national prerogatives and nationalistic scepticism of some member states; while according to the second one EU law is first of all great opportunity to invest on a larger market where common rules are accepted for most of the business operation.

This is also true for European tax law, but in this specific field the harmonising process has progressively slowed down through years for reasons that I’ll try to explicate in the following paragraphs. One remarkable exception in this respect is the taxation of the so-called ‘passive income’.²

II THE UNION, THE TREATIES, THE ISSUE OF DIRECT TAXATION

National states have always been jealous of their tax sovereignty, especially when it involves direct taxes. For this reason, when the Treaty of Rome was signed in 1957, and the Communities were created, a progressive harmonisation was considered in indirect taxes such as VAT and customs duties, but not in personal income or corporate ones.

In these latter fields, the Treaty used self-restraint to foster the bilateral relations between nations, especially through double taxation conventions (DTCs).³ In

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¹ Christopher Henry Dawson, *The making of Europe: an introduction to the History of European Unity* (3rd ed., 2003) 15.

² The concept of passive income is an authentic nonsense in most of the continental tax system, including the Italian one, so that is why I used the brackets. In the following paragraphs, however, I will use it in order to summarize dividends, royalties and interest payments across EU countries. Capital gains should be considered as well, but there are no EU Directives on Capital Gains Taxation so far.

³ Treaty establishing the European Economic Community (EEC), opened for signature 25 March 1957, 298 UNTS 11, art 293 (entered into force 1 January 1958). The EEC has been renamed the

subsequent years, however, it became more and more evident that the DTCs, although fundamental, were not enough to guarantee the full free movement of capital across the Community (later, the Union) and that the remaining differences between member states could constitute a limit to foreign investments in the common market as well.

The European Court of Justice (ECJ) played (and still plays) a fundamental role in this respect. The basic idea of the case law is that, even if direct taxation is excluded from an intervention by the Council, nonetheless the fundamental freedoms enshrined in the Treaty must be respected. In other words, where a direct intervention is lacking (or is not possible), a progressive interpretation of the four freedoms and the principle of non-discrimination could be successful, although in a sort of 'second-best' approach.

In recent years, academics and practitioners have recorded an ever-increasing number of cases decided by the ECJ using the Treaty in the field of direct taxes, but despite the efforts of the ECJ, it is evident that a harmonisation of such a complex field as direct taxation can not be achieved by the judiciary, which is limited to ruling on individual cases based on specific circumstances. More to the point, it is fundamental for the business to know exactly and in advance the amount of taxes to be paid and, even more to the point, what State would legitimately exercise its taxing powers in the EU framework, and obviously this need for legal certainty does not find an adequate answer in the decision by a Court composed by judges who come from 27 different jurisdiction, representing different legal traditions and have to decide sometimes on complex controversies applying the general principles enshrined in the Treaty.

This problem was particularly evident when flows of dividends, interests and royalties were considered, because of the more volatile nature of the underlying assets (while compared to business income or profit from real estate investments) and thus also the need for a level playing field across Europe was (and still is) more urgent. In other words, cross border participations in companies are more and more frequent in Europe (just like the licences of intangible properties and financial operations) because of the progressive harmonisation of the market, that's why the taxpayers need clear and accurate rules governing these operation, in order to avoid double taxation. This explains why the Union introduced a number of directives dealing specifically with some fundamental aspects related to *passive income* taxation.

The first ones (on dividends and Merger and Acquisition - M&A - operations)⁴ were implemented in 1990 and later updated and amended because of

European Community (EC) and the text of the Treaty has been changed and renumbered (now art 293 is 307) after the entry into force of the Treaty of Amsterdam on 7 May 1999 (1997) OJ C340. Consolidated versions of the Treaties can be found at (2006) OJ C321 E. All further references are to the consolidated version of the Treaties establishing the EC (the Treaty).

⁴ *European Economic Communities (EEC) Council Directive No 435/1990 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* [1990] OJ L225, 6. The directive was subsequently amended by the *European Community (EC) Council Directive No 123/2003 of 22 December 2003 amending Directive 1990/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* [2004] OJ L7, 41 and *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129. *European Economic Communities (EEC) Council Directive No 434/1990 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of*

the EU accession of the new states; another one (involving interests and royalties), although drafted in the same time, was not implemented for another 13 years.⁵ The aim pursued by the Commission was twofold: on one side the policymakers tried to avoid any double taxation within the European Union related to the free flow of these incomes. On the other side they indirectly offered foreign investors useful tools to optimise their investments across the continent. Even if Europe is still characterised by 27 different tax jurisdictions, the goal was to minimise such differences for those investing on assets, loans or intangibles in EU companies using EU parents established in any one of the European countries.

Unluckily, neither the text of the European Constitution signed in Rome⁶ nor the thinner text drafted by the Member states in Berlin and then developed in Lisbon⁷ seem to add anything interesting in this respect. Tax law is once more set aside by the European lawmakers: it could be argued that it is not considered a priority or (more likely) that it is still impossible to reach a unanimous consensus of the Member states to introduce common rules in direct taxes. This article reviews current *Eurotaxation* of passive incomes, focusing on the non-EU investor wishing to establish a subsidiary in Europe to obtain the highest return from investments in the EU.

III TREATY AND BOUNDARIES OF THE FREEDOMS: CITIZENSHIP AND RESIDENCE

The European harmonisation in direct taxation is grounded on the four freedoms⁸, the principle of non-discrimination, the right of establishment and the

shares concerning companies of different Member States [1990] OJ L225, 1. The Directive was subsequently amended by the *European Community (EC) Council Directive No 19/2005 of 17 February 2005 amending Directive 90/434/EEC of 23 July 1990 on the Common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States* [2005] OJ L58, 19 and *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129.

⁵ *European Community (EC) Council Directive No 49/2003 of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States* [2003] OJ L157, 49. The Directive was subsequently amended by *European Community (EC) Council Directive No 66/2004 of 26 April 2004 adapting various directives in the fields of free movement of goods, freedom to provide services, agriculture, transport policy, and taxation by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia* [2004] OJ L168, 35; *European Community (EC) Council Directive No 76/2004 of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain member states to apply transitional periods for the application of a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States* [2004] OJ L157, 108; *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129.

⁶ *Treaty establishing a Constitution for Europe* open for signature 16 December 2004 [2004] OJ C310 (never entered into force). *The Treaty of Nice amending the Treaty of the European Union, the Treaties establishing the European Communities and certain related Acts* open for signature 26 February 2001 [2001] OJ C80, should also be considered. So far, however, no specific provisions involve direct taxation.

⁷ *The Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community* open for signature 13 December 2007 [2007] OJ C306.

⁸ Namely, free movement of goods, services, persons (workers) and capitals

implementation of specific directives according to Art 94 of the Treaty:⁹ free movement of persons, goods, services and capital¹⁰ are of equal relevance, but in the light of this research the third plays a more relevant role as far as it is applicable to third countries investors as well. In this respect, while the non-discrimination principle still involves individuals and companies that are intrinsically members of the Union or there resident, it is the free movement of capital (and the freedom of establishment as well) which could arouse the interest of third countries' companies in particular.¹¹

A Free Movement of Capital

In a Treaty written by Europeans (and for Europeans) it could be considered almost impossible to find provisions drafted also to the advantage of (or at least taking into account) third-country individuals or legal bodies. This statement is not entirely accurate.

First of all, it was already pinpointed above that the free movement of capital is clearly and positively set also to the advantage of individuals and legal bodies resident or belonging to third countries:¹² in this respect the ECJ case law is relevant for third countries as well for European ones. As was noted by prominent academics, Art 56 can be now considered 'the most advanced and far-reaching provision in the EC Treaty in the relations with third countries',¹³ and the reasons of this extension towards third countries are better understood if, to a certain extent, the free movement of capital is seen as a sort of legal watchdog of the European currency, the Euro.¹⁴

Rather than attributing a unilateral gift to non-EU countries, allowing them a sort of free ride on one of the fundamental freedoms, the European lawmaker arguably wished to consolidate the reliability of the (future) currency and of the investment within the old continent: both inbound and outbound.¹⁵ This is the

⁹ Art 94 reads as follows: 'The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market'.

¹⁰ In the EC Treaty: Art 12 (prohibition of discrimination), 23 (goods), 39 (workers), 43 (establishment), 49 (services), 56 (capitals and payments).

¹¹ The most advanced research in European tax law is arguing about the possibility of extending the free movement of services to third countries as far as the movement involves EU citizens; see Pasquale Pistone, 'The Impact of European Law on the Relations with Third Countries in the Field of Direct Taxation' (2006) *Intertax* 235.

¹² Art 56 reads as follows: '1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited'.

¹³ Pistone, above n 11, 235.

¹⁴ This of course does not mean that the provision is void of any significance for the European countries which refused the Euro currency, such as the UK, being relevant as it is to any investment in assets or financial operations.

¹⁵ However Pistone, above n 11, 236, noted that the Advocate General Kokott (*Re Manninen* (C-319/02) [2004] ECR I-7477) seemed to limit the protection of Art 56 to the inbound investment (para 79 of the Conclusions). This interpretation is clearly inconsistent with the ratio which arguably inspired art 56 and its importance to enhance the reliability of the European currency

reason why understanding Art 56 and its limits (not present in the other freedoms) is of paramount importance for foreign investors wishing to allocate assets, participate in companies or finance them in Europe.

For the same reason, it is important to understand the case law that Art 56 brought about in the past when the effective safeguards guaranteed were benchmarked by practitioners. One of the most controversial aspects in this respect is the interaction between fundamental freedoms: it is clearly understood in case law that a very peculiar relation binds together Art 56 and Art 43, and where the latter is applicable the former is not. This mainstream interpretation actually led the ECJ to use Art 56 in a very limited set of cases, denying its relevance in each and every case when freedom of establishment was at stake.

The drawback of this approach is that as Art 43 has a narrower scope, not including third countries, the ECJ deny its protection, considering that when the circumstances of the case could fall *de facto* into Art 43 and Art 56 as well, only the first provision must be used. Furthermore, if the plaintiff is resident in a third country, then the freedom of establishment could not be used and therefore he was left without any European protection.

This ultimate consequence led many influent authors to stress the fact that in this respect EU law is not entirely coherent, because it seems to protect more (and better) the free movement of capital rather than the right of establishment. In other words, where a portfolio participation in a company, and its subsequent dismissal, would fall under the scope of Art 56, the creation of a branch or even a qualified participation in a subsidiary (granting the majority of votes, for example) would not.

These issues could be interesting not only for the protection of the participation as such, but even for the income yielded by it such as dividends or capital gains derived from the subsequent winding up of the company, or the sale of the portfolio. All in all, the problem can be summed up as follows: why EU law should protect a lesser form of investment and deny any protection to companies and individuals resident in third countries? The lack of overall coherence seems evident to the authors, who strongly criticised this outcome.

While this criticism is fundamentally right and therefore the opinion of the aforementioned authors should be supported,¹⁶ some arguments still exist in favour of the *status quo*. Basically the current interpretation seems to rely on a finalistic (or teleological) approach that also takes into account the asymmetry¹⁷ of the right attributed to an individual or to a company of a non-EU country.

The EU seems to encourage foreign investments and protect foreign payments in European companies, or in favour of EU established companies (or individuals as well); to this extent the basic condition is that the management of the company, its direction and the main decisions involving its business are placed in Europe. However, when a third-country investor moves into Europe with a branch, a permanent establishment or a similar device, while keeping abroad the place of effective management of the company, the situation suddenly changes

worldwide. Other reasons are clearly expressed and delineated by the previously mentioned author.

¹⁶ This is the opinion, for instance, of Advocate General P. Wattel, as reported by Pistone, above n 11, 237.

¹⁷ The free movement of capital protects third countries investors without any need of reciprocity in their home States in favour of EU investors.

and the protection of the Treaty decreases significantly. To this extent, the narrow interpretation of the ECJ seems to correctly balance the advantages that the EU grants for free to third countries individuals and legal bodies, or, more accurately, shows that the extension of Art 56 is not a gift at all, but rather an instrument to maximise specific investments, carefully selected, in Europe. The third-country investor must be aware that, when deciding on getting into Europe, it is not a paradox that the higher the investment, the lower the protection when the latter constitutes also an establishment of the business, falling outside Art 56.

B The Right of Establishment

In paragraph III A the free movement of capital was discussed on the basis that a specific provision of the Treaty (Art 56) clearly extended it to the advantage of investors resident in third countries. The issue related to the right of establishment is slightly more complex. Basically the Treaty defends the freedom establishment only so far as it is invoked by European *nationals*: however, it is still to be questioned who are European citizens.

At first glance the answer seems to be clear, given as it is by the Treaty itself. According to the fundamental text, European citizenship is embedded in the national one, in so far as a citizen of a Member State is also an EU citizen.¹⁸ However, while in the case of individuals the answer is simple and straightforward, in the case of legal bodies and companies the definition is partially different.

The notion of citizenship in this case is linked by the Treaty to the law of a Member state (any one of them) under which the company was constituted and where it has its registered office, central administration or principal place of business.¹⁹ According to Art 48, then, a non-EU company cannot enjoy the fundamental rights under the Treaty even if it has a permanent establishment or a subsidiary within the borders of the Union, nor if it claims that the place of effective management is European to all effects and purposes (in this latter case, however a different answer should be more appropriate *de iure condendo*²⁰).

The Treaty, however, does not seem to take into account the case of transfer of the main seat of a company from a third country to an EU one such as Italy, where foreign legal bodies are recognised by Italian international private law and allowed to be managed by the state of origin corporate governance rules (not conflicting in principle with Italian ones). A teleological interpretation could allow consideration as being 'formed in accordance' with the rules of a Member state those companies respecting the international private law principles of the latter. If this interpretation is accepted, then a company with its registered office in an EU country, but with the central administration or principal place of business elsewhere in the world, could qualify for the benefit of the Treaty. This is not the case with the directives mentioned above. The legislature clearly attributed the advantages of the provisions to companies formed according to any of the EU commercial laws, so far excluding companies incorporated abroad and then transferred within the EU. For this reason, a company incorporated in a third

¹⁸ Art 19 of the Treaty.

¹⁹ Art 48 Ibid.

²⁰ That is, according to law as it should be.

country (non European) will not qualify for the advantages of the directive even if it moves its legal seat within the EU.

IV DIVIDENDS *EUROTAXATION*: A PERSPECTIVE FROM ABROAD

The European directive providing for ‘a common system of taxation applicable in the case of parent companies and subsidiaries of different Member states’ was implemented in 1990 with a specific aim: to prevent double taxation on the flow of dividends running from subsidiaries to parents across Europe. It was clear that until 1990 the bilateral DTCs signed by the Member states were in most cases inadequate to the necessities of the common market, and that the cross-border nature of the dividends caused double taxation was inconsistent with the aims being pursued by the Treaty. The directive therefore tried to prevent this outcome by working on the two sides of the taxation on dividends: the possible withholding (or taxation at source) and the taxation in the home state of the parent company.

Withholding taxes on dividends are now prevented by Art 5, as introduced by Council directive 2003/123/EC; this is a straightforward rule that is applicable to the subsidiary state (this applies in most of the cases) and to the parent home state as well (Art 6). Taxation of the dividends as part of the taxable income of the parent company is still allowed, but in this case the home state must be ready to accept a tax credit equal to the amount of the corporate tax effectively levied on the business income of the subsidiary. Of course, the parent state can exempt the dividends attributed to the company, thus skipping the complexities of the credit calculation (Art 4).²¹

It could be argued, then, that the system depicted by the directive does not amount to a uniform system of dividend taxation across Europe, it is not a complex body of taxing rules individuating the taxable base, the rate applicable, etc., but rather an efficient mechanism to distribute the taxing power amongst the Member states in a way consistent with the Treaty and the needs of a harmonised common market.

So far the DTCs have been considered both insufficient (as potentially not covering all the possible flows of dividends across any EU state) and structurally inadequate (because of their intrinsic bilateral nature)²² to provide reliable rules to the Euromarket. However, where the debate within the Union is focusing on the notions covered by the directive and its effective application,²³ the interest of a third-country investor obviously focuses on the possibility of exploiting the advantages granted and the conditions to be met to qualify under the directive. Those possibilities are very limited so far. First of all, the directive clearly set out the qualifying subjects as companies’ resident within the EU and at the same time not resident abroad, according to a DTC between a third country and the EU state

²¹ This article was amended as well by the aforementioned 2003/123/EC directive.

²² Some exceptions do exist. This is the case, for instance, of some Nordic countries, which are experiencing a Multilateral Convention: see Marijaana Helminen, ‘Dividend, Interest and Royalties under the Nordic Multilateral Double Taxation Convention’ (2007) *IBFD Bulletin* 49.

²³ See amongst others *Bosal Holding BV v Staatssecretaris van Financiën* (C-168/01) [2003] ECR I-9409; *Océ van der Grinten v Commissioners of Inland Revenue* (C-58/01) [2003] ECR I-9809.

of the case. Secondly, the European rules clearly considers the case of the permanent establishment, but only if it belongs to another EU company.²⁴

According to these conditions, the only possibility that a third country investor has to exploit the directive goes through the creation of a subsidiary, namely a sub-holding, within the territory of the Union and in conformity to the commercial law of any of the Member states.²⁵ The selection of the state of the case clearly depends on the withholding taxes applied to the outbound dividends paid by the resident sub-holding to the third state resident parent company. Generally the choice falls on the Netherlands, Luxembourg or Ireland, although more recently Baltic countries are raising the interest of foreign investors as preferential entrance gates to the EU.

The directive also comes with an anti-avoidance provision, possibly also relevant for investors resident in third countries: Art 1, par. 2 clearly points out that anti-abuse or anti-fraud provisions shall be in any case applicable, despite the directive, when necessary. More to the point, the directive does not introduce a European notion of abuse, but rather makes reference to the rules already in force in the various Member states.²⁶ Even if at first glance, especially by a non-EU observer, such a provision could seem capable of restricting significantly the scope of the directive, it must be remembered that the ECJ had always judged strictly the compatibility of anti-abuse provisions (either unilateral or deriving from a bilateral agreement) with the European directives or the Treaty as well.

To this extent, a specific anti-avoidance provision must pass several tests aimed at verifying its proportionality, reasonableness and adequacy to reach the aim pursued while minimising EU rights and freedoms. Even in the recent past, the ECJ denied the compatibility with the Treaty of general anti-abuse provisions, such as the CFC ones in the UK, as they are too general in their scope and fail to aim at the very specific cases in which such avoidance (or abuse) effectively takes place. To a certain extent, the UK CFC provisions constituted a disproportionate infringement of fundamental freedoms that was considered as unacceptable by the Court.²⁷

Moreover, it is also important to remember that dividend payments could be covered by Art 56, as clarified in the former paragraph. To this extent, it could be argued that the Treaty is able to provide to investors resident in third countries better protection than the directive allows: despite the unfavourable outcome to the taxpayer, the *Holböck case*²⁸ would be considered a good starting point for future development of the principle.

²⁴ See art 2(2) as introduced by the 2003/123/EC directive. A clear reference to the permanent establishment was missing in the 1990 version, urging academics to question the analogical application of the EU provisions.

²⁵ The hypothesis put forward above at II (2) should be considered as purely theoretical and has never been tested by the ECJ.

²⁶ Ben Terra and Peter Wattel, *European Tax Law* (2005) 525.

²⁷ The case was decided by the ECJ under the freedom of establishment provision: the case was a purely European one with a company resident in the UK and another in Ireland (financing the first one): see Marco Greggi, 'Avoidance and *abus de droit*: the European approach in tax law' (2008) e-Journal of Tax Research Vol 6(1) 23-44). It is interesting to speculate what the outcome of the judgment would have been if a third-country company would have been involved, thus allowing a test of CFC regulations under Art 56.

²⁸ *Holböck v Finanzamt Salzburgland* (C-157/05) [2007] ECR I-4051; for an in-depth analysis, see Michael Lang, Joseph Schuch and Claus Staringer, *ECJ Recent Developments in Direct Taxation* (2006) 9.

V INTERESTS AND ROYALTIES: THE *BENEFICIAL OWNERSHIP* CLAUSE
AND THE CONSEQUENCES ON INVESTORS AND LICENSORS RESIDENT
IN THIRD COUNTRIES

The EU Commission has been working for several years on what we call today the ‘Interest and Royalty directive’. The first blueprint of the Directive was presented in 1990, together with the proposal for the ‘Parent–Subsidiary’ and the cross border ‘Merger and Acquisition’ ones; however the fate of the former was the more unfortunate of the two.

The concept inspiring this directive was simple and straightforward: royalties have to be taxed only once in the European Union, and this power has to be attributed to the country of the payee (Art 1(1) of the directive). The issues the directive addresses are different from the ones in the “Parent–Subsidiary”: in the case of interests and royalties, generally speaking, no double taxation occurs within the common market; while royalties are taxed upon the payee, they are at the same time generally tax deductible for the payer. The same goes for interest, even if some national limitations might occur.

The need for harmonisation was therefore less urgent, but even in this case the DTCs were considered insufficient to the common market and the administrative compliance costs connected to the payments and the compensation for the tax paid at source inconsistent with the Treaty. The preamble to the directive clearly refers to the ‘burdensome administrative formalities’ and ‘cash flow problems’ for the payee taxpayer to this extent.

Clearly, the cross-border royalty flows are not subject to international double taxation as dividends are in so many cases; more to the point, they are subject to juridical double taxation only.²⁹ This is due to the fact that, in most cases, royalties are a cost deductible by the payer (if the intellectual property is used for trade or business purposes), and the withholding tax, if not prevented by DTCs, is generally compensated by use of the tax credit mechanism.³⁰ The issue of double taxation was not therefore a priority for royalties as it was for the dividend case, and this situation can partially justify the delay of so many years in the implementation of directive 2003/49/CE.

However, while on one side the aim of the legislature was to foster the market, on the other side it was aware that in the case of royalties and interests the possibilities of improper tax planning would have been sensibly greater than in the case of dividends. As a result, the application of the directive (that is, the exclusion of any taxation at source for dividends and royalties payments) depends on two classes of anti-avoidance provisions, one being introduced directly by the EU legislator (namely, the ‘beneficial owner’ test) and the other one relying on the specific national rules.

The Directive uses the notion of ‘beneficial owner’ when dealing with the payee of royalties: basically, only the beneficial owner of royalties can qualify for the taxation at source exemption. Needless to say, the hardest part is the definition of beneficial owner in those systems (most of the continental ones) where such a

²⁹ While the dividends suffer also from the economical one, the distinction is clearly explained by Marijaana Helminen, *The Dividend Concept in International Tax Law* (1999) 9 and 38.

³⁰ Or the exemption mechanism in case the state of the payee chose this second solution in a way similar to the one in art 23B of the OECD Model.

notion simply does not exist and where the respective revenue services are almost free to shape it in the preferred way.

This objective condition of uncertainty (the ECJ has not expressed its view clearly yet) is particularly dangerous for the third-country investor who set up a sub-holding in Europe (as suggested in the former paragraph) in order to optimise his profits insofar as the sub-holding could be considered a ‘non-beneficial owner’ and thus disregarded for these purposes. To this extent, the only contribution possible to rely on is the interpretation of the concept in the application of the DTCs; even if the operation is not entirely correct under a purely dogmatic point of view, the concept is implemented there in the same way the EU lawmakers use it in the directive.

The authors³¹ who have discussed this topic pinpoint that the notion of ‘beneficial owner’ comes from common law, where it was used for the first time under trust law, to distinguish between ‘legal ownership’ and ‘beneficial ownership’ of an asset. This distinction is, however, impossible according to various continental laws (for instance, according to Italian civil law);³² therefore, the mainstream *doctrine*³³ argues that it is necessary to give the notion of ‘beneficial owner’ a completely different and autonomous meaning.

The text of the directive goes beyond the mere enunciation of the concept, adding that a beneficial owner is considered as such when it receives the royalty payment ‘for its own benefit, and not as an intermediary such as an agent, trustee or authorised signatory, for some other person’.³⁴

This approach must be followed carefully by the interpreter: to a certain extent, it could be argued, no sub-licensor would be considered a beneficial owner so far as the ultimate owner of the flow of royalties is the owner of the intangible. The same goes, *mutatis mutandis*, for the financing operations. This extremely restrictive interpretation of the provision could eventually lead to serious problems for all those third countries investors wishing to allocate their intangibles to a EU resident company using a licensing contract (behaving as a sub-licensor on the continent).

Others could argue that a sub-holding company operating as a financing entity (or as an intangible owner in conformity to a licence) could qualify as a beneficial owner as well. This requires the company to be able to demonstrate that the spread between the interest paid (to the non-EU resident holding company) and that gained by the financed company in Europe is fair, reasonable and consistent with the arm’s-length principle (that is, introduces a quantitative test). It is clear that qualifying a kind of income by using a quantitative approach is not always satisfactory under law, but in the absence of an ECJ clear position on this point and reading the text of the directive only, no other alternatives seem possible and maybe the distinction has really to rely on the differences in the amount of the

³¹ Charles Du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (1999) 99.

³² Italy implemented legislation on trusts very recently (in 2005), adding Art 2645 *ter* to the Civil Code.

³³ Luc Hinnekens, ‘European Commission introduces beneficial ownership in latest tax directive proposals adding to the confusion with regard to its meaning’ (2000) *EC Tax*, 43 and 44; David Oliver, ‘Beneficial ownership and OECD Model’ [2001] *British Tax Review* 65; Du Toit, above n 29, 145; OECD (ed.), *Commentary to the Model Tax Convention on Income and on Capital* (2003) 173 (more to the point above at para II(4)).

³⁴ Art 1(4).

paid royalties or interest. A purely anti-avoidance purpose³⁵ is attributable to two other fundamental provisions of the directive: Art 4, par. 2³⁶ and Art 5.

The first one includes some basic transfer pricing rules to the outgoing flows of royalties and interest: the Member State is allowed to tax at source the amount of royalties paid by the resident company (or permanent establishment) exceeding their arm's-length amount. Just as with every case involving transfer pricing, the anti-avoidance rule is applicable only if the payment involves two related parties, i.e. two associated enterprises. In the case of the directive, however, the lawmaker introduces the condition of a special relationship, saying that: 'Where, by reason of a special relationship ... the amount ... of royalties exceeds the amount which would have been agreed ... the provisions of this directive shall apply only to the latter amount, if any' (Art 4, par. 2). It is evident that this condition goes beyond the notion of associated enterprises (or companies) asking for something more to be verified for the application of the rule above mentioned.

In fact, all the companies according to the directive conditions must be necessarily associated if they want to take advantage of the taxation at source exemption; therefore, it could be argued that every royalty or interest payment under the directive falls also within the application boundary of the arm's length anti-avoidance rule. However, no details are given about the notion of 'special' relationship, which is quite new in EU tax law.

The consequence of this choice is that every state has been free to implement the rule as it wished to do, granting the taxpayer either a more limited or a wider leeway to define the amount of royalties paid and to have it both as tax deductible on the payer and at the same time not taxed at source because shielded by the directive. This is important particularly for the third country investor, who could be pushed to establish its sub-holding company in the European country where weaker anti-avoidance provisions exist to this extent.

In the case of Italy, for example, the legislature has interpreted the notion of 'special' relationship as the one provided for by the transfer pricing rules in direct taxation.³⁷ Basically the relation can be considered 'special' when one company controls another one, and in this way, in Italy, the conditions to be met to apply general transfer pricing rules and the limitation to taxation at source exemption are exactly the same.

The lack of harmonisation is evident in this case because of the fact that every state shall be free to interpret differently the notion of 'special' relationship, and this situation will surely lead to different meanings of the concept in different states, with an overall level of harmonisation that will be clearly reduced. The choice of not introducing autonomous concepts and the decision to refer to the separate national legal concepts is also adopted in the case of the other anti-

³⁵ The time dedicated to inquiry about the nature (anti-elusive or anti-fraud or not) of a provision in the directive could seem wasted under a practically oriented approach to the text of the directive and its implication in the different national law. In the Italian experience (at least) it is, however, fundamental to allow flexible, extensive or simply literal interpretation of the words and of the concept used by the legislature. The more a provision is finalised to contrast specific operations with a tax-avoidance purpose, the more the interpretation of that provision shall be restricted to those issues enumerated by the legislature.

³⁶ Art 4(1) also contains anti-avoidance provisions, but they are generally limited to interest payments covered by the directive together with royalties.

³⁷ Art 110, Italian Direct Taxation Act, T.U. 917/86.

avoidance (and anti-fraud) rules. They have a wider margin of application in this directive than has previously occurred³⁸ in the history of EU tax law, probably due to the concerns of the Council about an improper use of the taxation at source exemption.

Art 5 of the text clearly points out that the directive shall not prevent the application of any national anti-avoidance provision and that the states can suspend the application of its benefits when one of the principal motives of a transaction (that is, a licensing contract, for instance) is tax avoidance. The importance of this provision is evident as far as it allows the national lawmaker to suspend the directive (and the Tax office to deny its advantages), even if tax avoidance is only one motivation amongst the many which pushed the taxpayer to sign that specific licensing contract and to pay the royalties due: tax avoidance does not need to be the only motivation or the fundamental one in the overall operation.

Even if the article under examination (Art 5) sets out no specific limitations, it is possible to say that according to the general principles of European tax law, every limitation to the impact of the directive in national law must be consistent with the principle of proportionality. There must be an acceptable proportion between the infringement committed by the taxpayer and the consequences at law provided for by the lawmaker and applied by the Tax office.

VIM&A: CAPITAL GAINS TAXATION OF EUROPEAN COMPANY REORGANISATIONS

Both M&A and the issues related to company mobility could seem to fall, at first glance, outside the scope of this article and have nothing to do with capital gains taxation. No EU directive deals specifically and directly with capital gains taxation on the continent as the above-mentioned directive 435 does with dividends and 49 with royalties and interest, respectively. The absence of directives is arguably a consequence of both on the clumsiness of the decision-making process or, less likely, on a failure to understand the problem.

Capital gains realised on cross-border operations (involving assets, real estate or whatever else) can still be taxed according to the source rules (where the asset is located at the moment of its sale) or depending on the residence ones. These two approaches, most obviously, coexist even within the tax legislation of each Member state, depending on the nature of the asset, the operation performed or other factors.

In the case of Italy, for example, capital gains on real estate are taxed in the country if the individual or the company realising them is resident for tax purposes in Italy. On the contrary, the gains realised when selling a real estate located in Italy are always taxed in the country, whatever the residence of the parties involved. However, capital gains obtained on shares sold on a stock market are not taxed in Italy if realised by a non-resident investor. Similar rules are in force in various other continental countries, leading eventually to some cases of double taxation and others of double non-taxation, depending on the specific circumstances of the case. The first ones are resolved according to any applicable

³⁸ Excluding perhaps art 1(2) of the "Parent-Subsidiary" directive 1990/435/EEC.

DTC, while the others are tackled by national legislation as well, in most of the cases.

Despite the issues involved or the problems that could arise, the EU legislator was not able to rule about that, except for some specific cases: those involving company reorganisations (namely M&A operations) and the transfer of the seat of a specific company (the *Societas europaea*).

Basically, all M&A operations could determine capital gains as the difference between the book value of the assets involved and their market value at the moment of the operations (of the merger, for instance). The different tax legislation of the two countries involved could tax the gains according to different regulations, and, despite all this, the mere fact of considering an M&A operation an occasion to tax the accrued but not yet realised capital gains could constitute *per se* a limit on the implementation of such operations across the continent. This is the kind of issue that directive 1990/434/EEC addresses.³⁹

The EU legislature decided to qualify these kinds of operations as tax irrelevant, that is, no capital gains are deemed to be realised upon the implementation of such extraordinary corporate operations. Art 4 of the directive clearly set the rule applicable, deciding that an operation falling into the list in Art 1 does not give rise to any taxation on capital gains calculated as a difference between the real value of the assets (i.e. market value) transferred and their value for tax purposes.

However, even in this case the EU lawmaker clearly limited the applications of these provisions, using a different set of rules focusing on purely EU companies: that is, companies incorporated and resident for tax purposes within the EU. The annex to the directive, in clarification of Art 3(a), introduces a list of specific companies qualifying for the advantages of the directive and, subject to detailed conditions, capable of merging with others (or acquire them) in a tax-free system. These are the only circumstances where the EU provides a harmonised system of taxation of capital gains, or, in other words, the only case where the gains are not taxed at all.

The consequences of the implementation of this directive for third-country companies and investors are of less relevance. These economic subjects are excluded from the neutrality regime set up by directive 434 for the obvious reason of their non-EU condition. At the moment, a different solution seems impossible for the EU deliberately chose to limit the positive effects of the directive (that is the tax neutrality of the operation) to EU incorporated companies only, thus implicitly excluding the third countries companies even if they have their legal seat within the EU.

The only remark of some interest is, however, the one related to the mobility of the company within and outside the EU (intra-EU mobility and outbound mobility). Recently both the ECJ and the Commission have debated the issue of the transfer of the seat of one company from one Member State to another and, it could be argued, from the EU to a third country.

In this respect, the ECJ already ruled that most of the exit taxes that applied in these circumstances in the first hypothesis (intra-EU mobility of individuals) are against the freedom of establishment and Art 43 of the Treaty. The Commission added that in its point of view the same rule should be extended

³⁹ Art 1(a) of the directive rules that is applied to 'mergers, divisions, partial divisions, transfers of assets and exchanges of shares in which companies of two or more Member States are involved'.

to companies as well in cases of transfer of the seat from one Member State to another.

Companies resident in third countries should not underestimate the importance of these remarks. Should the Commission succeed in upholding its thesis in front of the ECJ, then possibly Art 56 of the Treaty would be full applicable to non-EU taxpayers as well: the conflict of a European exit tax with the free movement of capital in case a company participated in by a non-EU investor decides to move abroad could lead to a decision of the ECJ in favour of the foreign (non-EU) investor wishing to move the participated company away from the EU. Even if it is too early to raise such a question to practitioners and the more likely answer by now could be the one deciding in favour of the compatibility of such taxes with the free movement of capital, the remarks raised and the problem to be solved seem all but ill founded, at least considering the most likely evolution of the EU law in the next years.

VII CONCLUDING REMARKS

It is not easy to draw conclusion while dealing with a topic that is subject to continuous changes with the passing of months⁴⁰. The academic who begin this task could easily feel like the artist in 'The Draughtsman's contract' by Peter Greenaway: the scenario to be represented seems still but yet something differs day after day, and in the portrait there is always something misplaced or pointing at a hidden truth that lies beneath the appearance. Those who have seen the movie know that it is not wise for the painter (or for the author) to finalise the work, but as far as this paper deals with taxes only, some concluding remarks are possible, and hopefully riskless.

Passive income taxation in Europe is today regulated by a number of provisions that find their sources in the EC Treaty, in directives, in cases decided by the ECJ and in other European sources of law. For some specific third countries⁴¹, taxation of passive income is regulated also by peculiar agreements (Treaties) signed by the Union as such with them, pursuing the implementation of the 2003/48/EC Council Directive (the so called 'Savings directive').

The complexity of the sources of law is mirrored by the provision applicable to each kind of income: basically speaking, the EU gives priority to the taxing right of the state of residence, following closely the OECD approach in this respect, with the notable exception of the dividends, that are taxes where the subsidiary is placed (more to the point, an exemption is applied upon the parent company for almost the entire amount of them). The same goes for capital gains: where statutory regulations lack, the case law is applied; according to an ever increasing number of precedents the ECJ is aware of the unacceptable consequences of double taxation and of the fact that DTCs do not provide an adequate protection for that (the case of exit taxes, that generally are not covered by the treaties is a clear example in this respect). However, the priority in this case seems to be given to the inbound state.

Europe is not a federal state and probably will never be, despite the advantages that could derive from this final stage of the Community political

⁴⁰ For instance the recent *Cartesio Oktató és Szolgáltató bt v Hungary* (C-210/06) [2008] dated December 16th 2008.

⁴¹ Switzerland, San Marino, Andorra, Principality of Monaco, and Liechtenstein.

evolution: the awkward process of the European Constitution ratification is paradigmatic in this respect. Nonetheless much has already been done for what regards taxation law. The pattern of the above mentioned directives and cases created a sort of chessboard on which European (and foreign) investors can (reasonably) easily understand what is taxed, where and how much. For the latter category of taxpayers, Art 56 of the Treaty is still the most efficient shield to be used against the national tax authority of the case while trying to defend the investment or the income realized from a discriminatory or disproportionate taxation. It is a sort of back door from which the non-EU taxpayer can step into the common European house: hopefully, not Greenaway's Compton House.

ClientView



JULIE CASSIDY*

Apart from learning substantive legal principles, practising lawyers need to develop certain professional skills, such as client interview skills. The challenge at Deakin University was to find a mechanism that was accessible to Deakin's cohort of distance education students. 'ClientView' seeks to facilitate such through an e-simulation. Through ClientView the student interviews their new client, Miranda Koh. The e-simulation ClientView is designed to be used in company law and taxation units. It has since been used as the model for further e-simulations in the Faculty of Business and Law. This article discusses the use of e-simulations in legal education and in particular the development and implementation of ClientView.

I INTRODUCTION

Apart from learning substantive legal principles, practising lawyers need to develop certain professional skills, such as client interview skills. While an academic at each Bond University and Deakin University, the author sought to promote student development of such skills through role-playing in on-campus environments. The challenge at Deakin University was to find a mechanism that was also accessible to Deakin's cohort of distance education students. 'ClientView' facilitates such experiential learning through an e-simulation.

In 2004 the author was part of a group who successfully applied for a grant under Deakin University's Strategic Teaching and Learning Grant Scheme

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(‘STALGS’) for the project: ‘Experiential Learning Through Simulations: Enhancing education in the professions through interactive computer simulations online.’ The grant was administered by Deakin University’s Knowledge Media Department and involved a team of audio-visual experts, computer programmers, educationalists and academics from various Faculties. The latter were selected because of an existing interest in alternative teaching methodologies and it was perceived that the professional skills base of their units meant they would particularly benefit from the use of e-simulations. Building on an existing e-simulation for journalism students, ‘HOTcopy’¹, the grant enabled the design and development of five e-simulations in 2006-2007 for use in psychology,² forensics,³ public relations,⁴ computer information systems⁵ and law.⁶

The use of e-simulations at Deakin University involves both what Klabbers calls Design-In-the Large (‘DIL’) and Design-In-the Small (‘DIS’).⁷ In regard to the former, Deakin University has embraced the use of e-simulations as a strategic part of its teaching of professional skills. These five e-simulations have provided models⁸ for the development of further e-simulations.⁹ The e-simulations are now part of the broader institutional wide InSims program.¹⁰ As to DIS, there is no single model for the e-simulations. The academic dictated the specifics of each of the five e-simulations in light of the professional skills base of the relevant discipline.

This article primarily focuses on the e-simulation ClientView that is designed to be used in company law and taxation units; both being teaching areas in which the author is involved. Through ClientView the student interviews their new client, Miranda Koh. There are three sessions. In Session 1 the student has their first meeting with Miranda, who is seeking advice as to an appropriate business structure for a new venture. In Session 1 Miranda explains to the student her circumstances and there is no ability for the student to ask questions. In Session 2 the student has a second meeting with Miranda, where they can ask her questions. In Session 3, Miranda has requested a further meeting, after she has read the student’s letter of advice, to discuss the suitability of the business

¹ ‘HOTcopy’ simulates a newsroom professional internship experience where students take on the role of reporter. ‘HOTCopy’ has received numerous institutional and national awards and is now published by Allen Unwin. See www.hotcopy.infor/guest/awards/index.htm.

² ‘Mods & Rockers’ allows students to interview three practicing psychologists.

³ ‘Unreal Interviewing: Forensic Interview of a Child’ allows students to role-play as a police officer and interview a child witness for forensic purposes.

⁴ ‘Pressure Point! Virtual Practice: Getting Framed’ allows students to role-play three opposing public relations practitioners.

⁵ ‘First Australia Bank: Automatic Teller Machine (FAB-ATM) Project’ allows students to role-play an information systems consultant interviewing two bank employees in regard to the design of an ATM.

⁶ ‘ClientView’ allows students to role-play as a solicitor interviewing a client. This is discussed in more detail below.

⁷ See further JHG Klabbers, ‘Simulation and gaming: Introduction to the art and science of design’ (2003) 34 *Simulation and Gaming* 448; ‘Simulation and gaming: Principles of a science of design’ (2003) 34 *Simulation and Gaming* 569.

⁸ For example, ClientView, the subject of this article, provided the model for the 2008 e-simulation ‘Blue Apple Cruises’ which is used in teaching financial planning.

⁹ For example, ‘Penfield Virtual Hospital’ is used in teaching nursing and ‘NewLandia’ is used in teaching professional writing.

¹⁰ See further as to Deakin University’s ‘InSims program’ www.deakin.edu.au/alt/insims/index.php/Main_Page.

structure(s) suggested in light of late changes to her circumstances. Before more closely considering the design features of ClientView and the educational features of the e-simulation, the article provides a brief literature review of e-simulations in law.

II LITERATURE REVIEW

While there is a substantial body of work on the educational benefits of simulations, literature examining the use of e-simulations in the teaching law is comparatively limited. Nearly all the literature in this specific area is written by Maharg and/or his co-authors, discussed below. This is in turn linked back to the fact that initially e-simulations were used primarily in science related subjects¹¹ such as medicine and nursing. Obviously, it is critical that students in these fields practice skills before they are required to do so in real life.¹² It is only in more recent years that e-simulations are being used in a broader pattern to include humanities subjects.¹³ Moreover, while the potential benefits that e-simulations could provide in legal education were noted over a decade ago,¹⁴ legal education has been 'slow to discover that virtual simulation is a valuable method of learning about the law, the legal profession and its transactions.'¹⁵

The use of e-simulations in law continues to be rare. Apart from the relatively early discussion by Widdison et al,¹⁶ from a literature review there appears to be only one documented example of an e-simulation being used in legal education; namely Maharg's virtual simulation¹⁷ used in teaching legal practice at, *inter alia*, Glasgow Graduate School of Law, University of Strathclyde. In his 2001,¹⁸ 2002,¹⁹ 2004,²⁰ 2006²¹ and 2007²² papers Maharg

¹¹ C Aldrich, *A field guide to educational simulations* (2003), 8; P Maharg and M Owen, 'Simulations, Learning and the Metaverse: Changing Cultures in Legal Education' (2007) 1 *International Journal of Information, Law, and Technology* (http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2007_1/maharg_owen), [2].

¹² C Aldrich, *A field guide to educational simulations* (2003), 8.

¹³ See further J Lean, J Moizer, M Tower and C Abbey, 'ESimulations and games: Uses and barriers in higher education' (2006) 7 *Active Learning in Higher Education* 227.

¹⁴ See R Widdison, M Aikenhead and T Allen, 'Computer simulation in legal education' (1997) 5 *International Journal of Law and Information Technology* 279. See also R Widdison, M Aikenhead and T Allen, 'Exploring Law Through Computer Simulation' (1999) 7 *International Journal of Law and Information Technology* 191.

¹⁵ P Maharg, 'Legal Sims: From Everquest to Ardcalloch (and Back Again),' CALI Conference, Seattle 17-19 June 2004 (<http://www.caliauthor.net/conference/2004/presentations/Legal%20Sims.doc>), 1.

¹⁶ R Widdison, M Aikenhead and T Allen, 'Exploring Law Through Computer Simulation' (1999) 7 *International Journal of Law and Information Technology* 191.

¹⁷ The e-simulation builds on an earlier pilot project Virtual Court Action, a computer based learning program designed to teach students court procedure by allowing students to role-play as prosecutors and defenders in a hypothetical court action. See K Barton, P McKellar and P Maharg, 'Situating Learning and the Management of Learning: A Case Study' (2000) 9 *Legal Education Digest* 15.

¹⁸ P Maharg, 'Negotiating the Web: Legal Skills Learning in a Virtual Community' (2001) 15 *International Review of Law Computers & Technology* 345.

¹⁹ P Maharg, 'IT's Progress: The Gradual Revolution' (2002) *The Legal Executive Journal* 8; P Maharg, 'Transactional Legal Learning on the Web' (2002) 2 *Legal Information Management* 26.

²⁰ Above n 15; P Maharg, 'Virtual Firms: Transactional Learning on the Web' (2004) *Journal of the Law Society of Scotland* (<http://www.journalonline.co.uk/Extras/1001154.aspx>).

²¹ P Maharg, 'Authenticity in Learning: Transactional Learning in Virtual Communities' in (2006)

describes his development of a virtual legal community on the web. Students are divided into law firms and in this on-line environment they role-play as solicitors in the virtual town of Ardcalloch, interacting with businesses and legal institutions. The virtual town Ardcalloch has provided the basis for a much larger project called SIMulated Professional Learning Environment ('SIMPLE'),²³ involving the large-scale implementation of simulations across a number of law schools.²⁴ Maharg et al²⁵ describe how pursuant to this project they have sought to improve the teaching of professional skills by focusing the School's curriculum around e-simulations. This was important, as the authors have concluded that the success or failure of e-simulations can be determined by its place in the broader curriculum.²⁶

In later publications²⁷ in particular Maharg et al examine the research into scientific discovery learning and draw parallels with their e-simulations. Ultimately they argue that the effectiveness of e-simulations in law very much depends on the design of the particular e-simulation and its learning outcomes.²⁸ This point has been subsequently reiterated by Maharg²⁹ where he stresses that e-simulation must be very much discipline driven in terms of learning outcomes.

A premise of Maharg's e-simulation is that experiential learning is more effective than learning undertaken in a formal academic setting.³⁰ In fact it is contended that there may be some forms of learning that can only occur if the students actually go through the process of carrying out the transaction.³¹ It is suggested below that what Maharg³² calls 'performative' legal skills, for example, interviewing, negotiation and advocacy skills, fall into this category. In turn the e-simulation is based on an approach to professional learning that is called 'transactional learning.'³³ Transactional learning is 'active learning, not passive.'³⁴ '[T]ransactional learning goes beyond learning *about* legal actions to learning *from* legal actions.'³⁵ Students need to be 'involved in activities within

Innovating e-Learning Practice, The Proceedings of Theme 3 of the JISC Online Conference: Innovating e-Learning 61; P Maharg, 'On the edge: ICT and the transformation of professional legal learning' [2006] 3 *Web Journal of Current Legal Issues* (<http://webjcli.ncl.ac.uk/2006/issue3/maharg3.html>). See also K Barton and F Westwood, 'From student to trainee practitioner – a study of team working as a learning experience' [2006] 3 *Web Journal of Current Legal Issues* (<http://webjcli.ncl.ac.uk/2006/issue3/barton-westwood3.html>).

²² Above n 11.

²³ See further K Barton, P McKellar and P Maharg, 'Authentic Fictions: Simulation, Professionalism and Legal Learning' (2007) 14 *Clinical Law Review* 143; above n 11.

²⁴ The e-simulation is now also used in teaching law in other partner institutions such as University of the West of England, University of Warwick and University of Stirling: P Maharg, *Laminations: Dewey, constructivism & professional education* (www.slideshare.net/paulmaharg).

²⁵ Above n 23.

²⁶ Above n 17; Maharg and Owen, above n 11; above n 24.

²⁷ K Barton and P Maharg, 'E-simulations in the Wild: Interdisciplinary Research, Design and Implementation' in C Aldrich, D Gibson and M Prensky (eds), *Games and Simulations in Online Learning: Research and Development Frameworks* (2006) 116; Maharg and Owen, above n 11.

²⁸ Barton and Maharg *ibid*; Maharg and Owen, above n 11.

²⁹ Above n 24.

³⁰ Above n 24.

³¹ Maharg and Owen, above n 11, [16].

³² Above n 15, 3.

³³ Above n 11, [15].

³⁴ Above n 15, 15; Maharg and Owen, above n 11, [16].

³⁵ Maharg and Owen, above n 11, [16] (emphasis in original).

legal actions, rather than standing back from the actions and merely learning about them.’³⁶ In turn it is suggested that simulation is one of the most effective ways to teach skills-based learning.³⁷ Ultimately Maharg believes e-simulations enable more engaged and deeper learning.³⁸ These conclusions are supported by student feedback. This indicates that students’ professional skills were enhanced by the project, they developed a heightened awareness of client care, improved their IT skills and developed a fuller understanding of the subject matter.³⁹ Ultimately Maharg et al argue that projects such as SIMPLE are essential to legal education.⁴⁰

The only other related example is the use of Stream Indexing and Commenting System (‘STICS’) at Nagoya University’s Graduate School of Law in Japan. This does not strictly involve the type of e-simulation being considered in this article. Rather the project involves student simulations that are accessed by their teachers using information systems. More specifically, in their 2005 conference paper⁴¹ the authors explain that STICS is a software system that allows professors to attach written comments to streamed videos of students role-playing as lawyers in, for example, a mediation. The benefits of using STICS were said to be the ability to provide an individualised learning environment and the promotion of student reflection and analysis. In their 2007 conference paper⁴² the authors discuss improvements that have been made to STICS. In particular they discuss the benefits of a collaborative learning environment and the strategies adopted to overcome the students’ reluctance to share the comments on their video clips.

While the discussion below of ClientView concentrates primarily on DIS, in light of the limited documented use of e-simulations in teaching law it nevertheless makes an important contribution to the literature in this field.

III LIMITATIONS TO THE E-SIMULATION

By their very definition, simulations ‘are tools that give you ersatz (as opposed to real) experience.’⁴³ Thus while educational simulations ‘place students in true-to-life roles’ and the ‘simulated activities are “real world”, modifications occur for learning purposes.’⁴⁴ To this end the Introduction to ClientView explains to the student that because it is an e-simulation, there are some limitations in terms of replicating a real life interview. As explained below, these are designed to enhance the learning experience.

³⁶ Above n 35.

³⁷ Maharg and Owen, above n 11, 5.

³⁸ Above n 24.

³⁹ Above n 18, 356-357; above n 15, 18-19; above n 24.

⁴⁰ Maharg and Owen, above n 11.

⁴¹ D Kaneko and S Ijuo, ‘Classroom Practice by Using Tools for Legal Skills Education,’ *2005 Proceedings of World Conference on E-Learning in Corporate, Government, Healthcare and Higher Education* 1658.

⁴² D Kaneko, S Ijuo and A Ayuma, ‘Class Design Using STICS for Professional Training in Legal Education,’ *2007 Proceedings of World Conference Educational Multimedia, Hypermedia and Telecommunications* 2259.

⁴³ M Prensky, *Digital Game-based Learning* (2001), 1.

⁴⁴ JP Hertel and BJ Millis, *Using simulations to promote learning in higher education: an introduction* (2002), 16.

ClientView

Transcript

Jack McInerney

In this Session you will be meeting your client, Mrs Miranda Koh, who is seeking advice from you. She has business experience, but not legal expertise. As a business woman Miranda would have some basic knowledge of various business structures. As she is not expected to have any legal expertise she would not know who these structures are created for or the legal consequences of creating and using them. Are you ready to meet your client? Do you have your notepad and pen ready?

Elapsed time 00:00:12

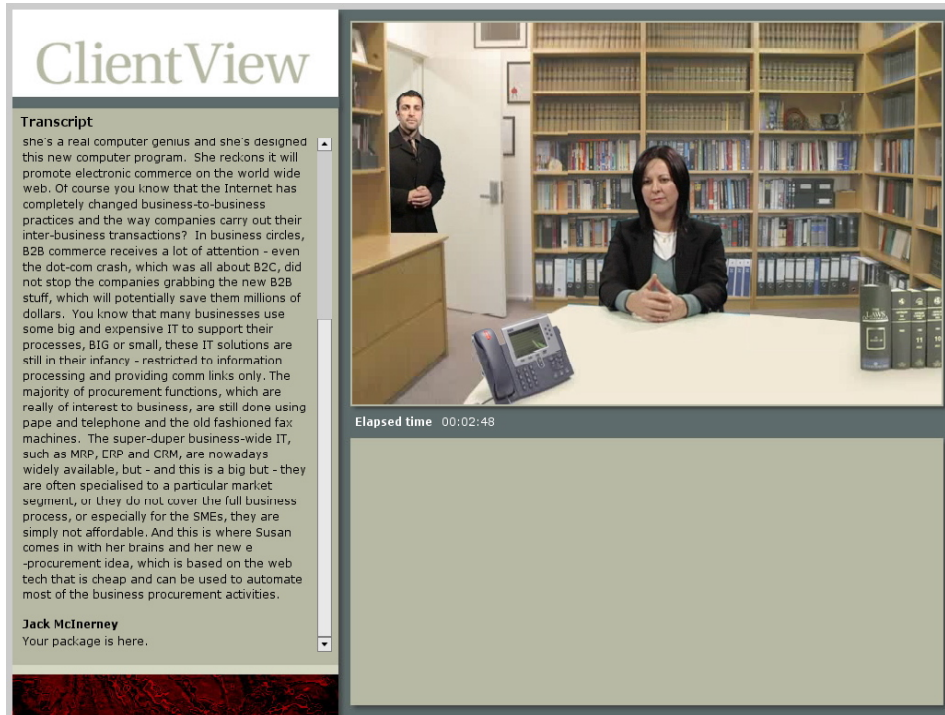
First, a transcript is provided. While this undermined the development of student note-taking skills, this feature is primarily included to promote equity. Enrolments in the relevant units have included some profoundly deaf students. While the feature was primarily included for such students, as ClientView is integrated into the units assessment, it was determined that it was fair to extend this added facility to all students, not just the hearing impaired. Ultimately, ClientView's objective is 'learning' and a transcript will assist the students in completing the assessment task.

Second, the student can play the ClientView CD as many times as they like. Whether to include such a feature, rather than technically limiting the CD to just one play, was a difficult decision. To replicate a real interview, logic dictated that the student only be allowed to run a particular session once. Again, however, as the task was assessable it was concluded that the student should be able to review the e-simulation. Moreover, the reality was that a student might be interrupted in the course of running ClientView, so it was necessary that they be able to access the session more than once.

IV REPLICATION OF AN OFFICE INTERVIEW

The fidelity of an e-simulation, in terms of its replication of real life, is of course crucial to its effectiveness.⁴⁵ To this end one important feature of ClientView is the replication of an office environment. To that end two interruptions are included in the course of Session 1, the first meeting with the client Miranda. Both of the interruptions were based on personal experiences when working with solicitors/barristers in their offices/chambers.

⁴⁵ See further T Stoffregen, B Bardy, LJ Smart and R Pagulayan, 'On the nature and evaluation of fidelity in virtual environments' in L Hettinger and M Haas (eds), *Virtual and adaptive environments: applications, implications, and human performance issues* (2003) 111.



First, at one point the student's personal assistant, Mr McInerney, interrupts the meeting with Miranda, by informing the student interviewer that a package has arrived. Second, the phone rings. It is the senior partner wanting an urgent response in regard to the progress of a Statement of Claim. During this reasonably lengthy phone discussion the client, Miranda, becomes impatient and ultimately indicates that she has to leave. This was the impetus needed to end the first session before the client had provided all the important relevant information to the student interviewer.

ClientView also seeks to replicate the real life interview experience in terms of Miranda's answers to the student's questions in Session 2. If the student asks the same question twice Miranda responds by asserting "Haven't I already answered that?" Further, if there is an excessive pause in the Session 2 interview Miranda appears bored and fidgety and at times asserts "I'm a busy person you know."

V PROFESSIONAL SKILLS

As noted above, the aim of ClientView is to develop relevant professional skills through student role-playing as a solicitor. In the course of the interview the student:

- practices note-taking skills;
- develops an ability to discern relevant/irrelevant material provided by the client; and
- develops the ability to ask relevant questions.

In regard to these skills, once the final version of ClientView is developed, the student will not know there are three sessions. The final version of ClientView will be on-line through Deakin's newly developed 'Conversational Character' server. This will enable the selected release of each subsequent session once all

students have, for example, completed the previous session. This will ensure that the student focuses on Session 1 as potentially the only source of relevant information.

There is a debrief screen at the end of each session where the student can register comments about their experience and, in particular, note any further information they require. While that information may be provided in Session 2, it also allows the teacher to address, and respond to, say, any factual omissions. This debrief screen will be particularly important once the ability to selectively release each session is in place. Moreover, once ClientView is on-line the student's comments in the debrief screen will be directly forwarded to the teacher via the University's email system.



As noted above, the final version of ClientView will be offered on-line. The student will need to log into the University internet system to access ClientView. Currently the CD is run off-line and is a stand-alone product that does not need to be supported by any computer application, such as Quick time. Even once ClientView is offered on-line, where a student is studying in a remote area where internet access may be difficult, they will be allowed to undertake the task off-line.

ClientView

Transcript

she's a real computer genius and she's designed this new computer program. She reckons it will promote electronic commerce on the world wide web. Of course you know that the Internet has completely changed business-to-business practices and the way companies carry out their inter-business transactions? In business circles, B2B commerce receives a lot of attention - even the dot-com crash, which was all about B2C, did not stop the companies grabbing the new B2B stuff, which will potentially save them millions of dollars. You know that many businesses use some big and expensive IT to support their processes, BIG or small, these IT solutions are still in their infancy - restricted to information processing and providing comm links only. The majority of procurement functions, which are really of interest to business, are still done using paper and telephone and the old fashioned fax machines. The super-duper business-wide IT, such as MRP, CRP and CRM, are nowadays widely available, but - and this is a big but - they are often specialised to a particular market segment, or they do not cover the full business process, or especially for the SMEs, they are simply not affordable. And this is where Susan comes in with her brains and her new e-procurement idea, which is based on the web tech that is cheap and can be used to automate most of the business procurement activities.

Jack McInerney
Your package is here.

Elapsed time 00:02:48

In regard to note-taking and the ability to discern relevant/irrelevant material provided by the client, as noted above, in Session 1, the first meeting with Miranda, there is no ability to ask Miranda questions. From Miranda's explanation of the basis for her new business venture in the area of e-commerce, the student identifies and notes relevant facts. Again to replicate a real life client interview, Miranda addresses both relevant and irrelevant matters. For example, Miranda's explanation includes a long screed on e-commerce. While the session only runs for 4 minutes, it seems an eternity as Miranda garbles on about technical e-commerce issues. Thus the student must be discerning as to whether the information Miranda provides is in fact relevant.


ClientView

Transcript

Jack McInerney
In this Session you will be given the opportunity to ask questions of your client, Mrs Miranda Koh. As your time with the client will be limited, it is important that you focus on asking her the most relevant questions. Are you ready to meet your client? Do you have your notepad and pen ready?

Interviewer
How can I help you?

Miranda Koh
I want to find out what business structures are open for me and which one would be most suitable for the venture.



Elapsed time 00:01:44 Prompt Gender: Male Female

Advice sought	Personal	Involvement in the Business	Plant and Equipment	Capital	Risk	Computer Questions

With respect to the ability to ask relevant questions, in the Introduction to Session 2, the student is informed ‘you will be given the opportunity to ask questions of your client, Mrs Miranda Koh. As your time with the client will be limited, it is important that you focus on asking her the most relevant questions.’ The questions are categorised into themes, indicated in the above slide. Note there is a gender prompt so that the student may ask their questions in a female or male voice. When the final version of ClientView is connected to the University’s internet system, this will track which questions the student asks. This will enable the teacher to gauge the appropriateness of student questions and responses.

ClientView

Transcript

Jack McInerney
In this session you will again meet with your client, Mrs Miranda Koh, after she reads your letter of advice, to discuss the suitability of the business structure you have suggested. Are you ready to meet your client? Do you have your pen and notepad ready?

Miranda Koh
Well, I carefully read your letter and it makes a lot of sense to me. The only thing I wanted to talk to you about today is that things have changed a bit. You see, I’ve spoken to Susan and it seems she’s gone to some copyright lawyer and he has done something, I don’t know what, but it looks like we really have no risk in that regard now. Also, I’ve sort of had a bit of luck. It’s sad really, but also at the same time a bit fortunate. My favourite aunt has passed away and she had no kids so everything was left to me. So I don’t have to go to the bank now. Will this change things?



Elapsed time 00:01:04

In Session 3 the ability to identify relevant facts is further tested. As noted above, here Miranda has requested a further meeting, after she has read the student's letter of advice. Miranda asks the student interviewer whether certain changes in her factual circumstances impacts on the advice she has been given. The student is then given an option to change their advice in light of these new facts.

VI STUDENT COHORT

ClientView is designed for use in both taxation and company law units. It is suitable for undergraduate law and commerce programs, but would also be well suited to postgraduate units. In the case of company law units, the assessment task is a letter of advice on the various business structures available to Miranda. In the case of taxation units, the advice is confined to the taxation implications of the various business structures.

In semester 2 2007 ClientView was trialled for the first time with the final year bachelor of laws students undertaking MLL 406 Taxation. They used ClientView as the basis of an optional assignment that was worth 40 percent of the final mark in the unit. As it was an optional assignment, ultimately only a small group trialled ClientView. In semester 1 2008 ClientView constituted the primary interim assessment task in the bachelor of laws unit MLL 221 Business Organisations. In semester 2 2008 ClientView again provided the basis for the optional assignment in MLL 406 Taxation.

VII EVALUATION OF CLIENTVIEW

A Teachers' perceptions

The formal evaluation of the teachers who used the STALGS e-simulations, discussed below, and the author's personal self-reflection highlights a number of the same issues raised in the above literature review.

In 2006 the education designer who administered the above-discussed STALGS grant, Mr Stephen Segrave, was assisted by Ms Mary Rice to investigate what the teaching staff thought about using the e-simulations. Interviews were conducted with, *inter alia*, each of the five academics involved in the 'Experiential Learning Through Simulations' project, including the author. The interviews revealed a strong synergy in the academics' experience in respect to desired teaching and learning outcomes.⁴⁶ 'The development of thinking professionals was a clear goal of the teaching strategies underpinning e-simulations. Rather than become technicians implementing recipe style solutions, the notion of presenting experiences that would challenge and change students' thinking was highlighted.'⁴⁷ In turn the academics believed that the e-simulations provided a valuable means of introducing students to higher order work-related

⁴⁶ See further S Segrave and M Rice, *University teachers' conceptions of the nature and value of digital eSimulations for teaching and learning* (2007) unpublished internal report Institute of Teaching and Learning, Deakin University.

⁴⁷ Above n 46, 6.

skills such as decision making, analysing and interpreting information and discerning what was relevant.⁴⁸

In terms of self-reflection, two interrelated points can be made in regard to these comments. First, a premise of the development of ClientView was that the most effective skills-based learning occurs through simulation. In this case this occurs through the interviewing of the client, making strategic decisions based on the information provided and the student's legal knowledge and the creation of a legal document, a letter of advice. Moreover, as stated above, the author believes that some skills can only be learned by actually undertaking the 'transaction' (to use Maharg's terminology).⁴⁹ Interviewing skills fall into the category of 'performative' legal skills⁵⁰ that can only be learned through actual practice through performance. Thus from a teacher's perspective, ClientView's facilitates the 'transactional learning'⁵¹ of, *inter alia*, interview skills by all streams of students, including those studying by distance education, and thereby fills an otherwise gap in the author's teaching of professional legal skills. Second, the e-simulation provides a framework for the development of skills that is integrated with substantive legal knowledge. This is the crucial aspect of the e-simulation that enables the development of what Biggs refers to as 'functioning knowledge.'⁵² In turn this facilitates a deeper practical understanding of the law that ensures the above-discussed development of thinking professionals, rather than 'technicians implementing recipe style solutions.'⁵³

In the interviews the teaching staff emphasised that the non-threatening e-simulation environment was preferable to the real work place for learning these professional skills.⁵⁴ The benefit of e-simulations is that they operate in a 'virtual world, relatively free of the pressures, distractions and risks of the real one, to which, nevertheless it refers.'⁵⁵ ClientView enables students to practice legal skills that they will soon be practicing with real clients in relation to real legal transactions. Most importantly, this learning environment is safe. E-simulations allow students to experience and learn from their mistakes without any professional risk to themselves, their employer or their clients.

Integrating the e-simulations into the assessment of the unit was considered important by each of the academics.⁵⁶ They recognised that the skills learnt through the e-simulation were important and valid and thus the e-simulations needed to be incorporated into the overall assessment.⁵⁷ The underpinning conclusion was that assessment drives student learning.⁵⁸ In turn the assessment tasks were strategically focused on the higher order skills required by the relevant profession.⁵⁹

⁴⁸ Above n 46, 3.

⁴⁹ Above n 11, [16].

⁵⁰ Above n 15, 3.

⁵¹ Above n 11, [15].

⁵² J Biggs, *Teaching for Quality Learning at University* (2002), 40.

⁵³ Above n 46, 6.

⁵⁴ Above n 46, 3.

⁵⁵ Schon, *Educating the reflective practitioner* (1987), 37.

⁵⁶ Above n 46, 6.

⁵⁷ Above n 46.

⁵⁸ Above n 46.

⁵⁹ Above n 46, 7.

Ultimately, the academics found the e-simulations to solve teaching problems in relation to the deliver of professional skills and provided a rich, motivating, multimedia-based experience for students.⁶⁰

B Students' perceptions

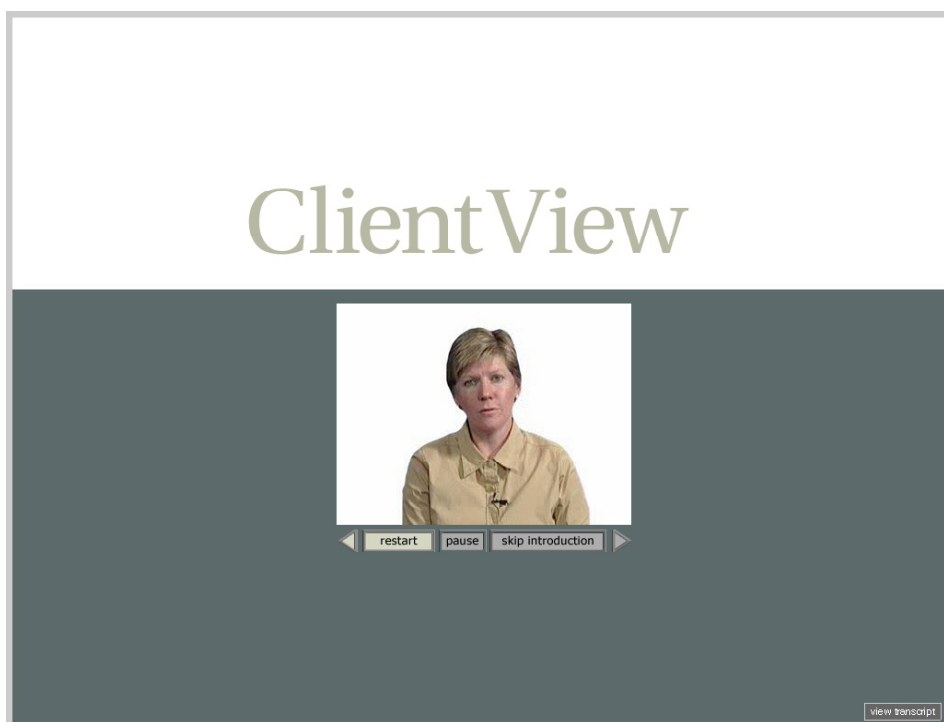
The learning experience from ClientView has not been formally evaluated as yet. Deakin University's Institute of Teaching and Learning is currently leading an ALTC funded project in partnership with the Royal Melbourne Institute of Technology ('RMIT') and Charles Sturt University aimed at transforming professional learning through the design and development of e-simulations. Part of the project will entail gathering data on students' experiences in relation to the e-simulations being used in the three institutions. It is expected that the ethics approved survey would be used for the 2009 offering of the unit MLL 406 Taxation in tri-semester 2.

In the interim, some students have provided the author with feedback. Overall this has been very positive. Students found this to be a fun way of undertaking the task and saw it as a positive feature in the Deakin Law School's promotion of practical legal skills. Surprisingly, some of the 2007 Taxation students found the assessment task a little daunting. The reason for the author's surprise is that they had completed a similar (but not through an e-simulation) mandatory interim assignment in their earlier unit MLL 221 Business Organisations. The students' perception as to the difficulty of the task has been addressed through a fuller explanation at the outset as to what is expected from the students.

Ultimately, the students found the ClientView CD easy to use. Only one 2007 Taxation student encountered problems running the CD. The reason remains unclear as the e-simulation is a stand-alone program that does not need to be supported by another computer application. The only suggestion to date is that the student's computer may have been very old and thus unable to run even very basic computer systems. At the beginning of semester 1 2008 some students using IBM computers were having trouble running the e-simulation. It was concluded that this was caused by the new version of Vista. In the interim students were advised to ensure Vista was turned off before running the e-simulation. Ultimately the problem was addressed and no 2008 Taxation students had any difficulties in running the CD.

⁶⁰ Above n 46, 4.

VIII CONCLUSION



As with Maharg's experience, ClientView is now part of the larger-scale implementation of e-simulations. As noted above, it is part of the broader institutional wide InSims program⁶¹ that Deakin University sees as a strategic part of its teaching of professional skills. Moreover, as also noted above, ClientView will in the future also play a part in a broader cross-institutional project. Deakin University's Institute of Teaching and Learning ALTC grant will provide an important gathering of data on students' experiences of all e-simulations being used in the three institutions. This evaluation will enable the author and other relevant teachers to reflect of our own use of e-simulations, but also provide the teaching institutions with data for their intended expanded use of this experiential teaching tool.

In terms of the author's experience, creating ClientView has been a challenging and rewarding experience. While the underlying software was crucial in terms of achieving the learning outcomes sought, as Stewart and Brown note 'one of the hardest tasks is the planning and storyboarding of the scenario itself.'⁶² This was far more time consuming than the author expected. In turn, the time required to develop an e-simulation has been seen by academics as a major barrier to their use.⁶³ While the design and development of the initial five e-simulations

⁶¹See further as to Deakin University's 'InSims program' www.deakin.edu.au/alt/insims/index.php/Main_Page.

⁶² TM Stewart and ME Brown, 'Developing interactive scenarios: The value of good planning, whiteboards and table-based schemas' in *Hello! Where are you in the landscape of educational technology?* (<http://www.ascilite.org.au/conferences/melbourne08/procs/stewart.pdf>), 983.

⁶³ See further PJ Francis and AP Byrne, 'Use of role playing exercises in teaching undergraduate astronomy and physics' (1999) 16(2) *Publications of the Astronomical Society of Australia* 206; B

was extremely time consuming and expensive, the subsequent e-simulations have been produced quite quickly as they have been able to use the former as models. Thus the initial outlay of time and money has provided the foundation for the broad institutional wide InSims program. Also, as indicated by the above discussed survey of the five academics involved in the initial e-simulations, ultimately all concluded that the learning outcomes were worth the effort.

Personally, in the course of the project the author learned a little about learning paedology and script writing. The author has a newly found respect for 'Neighbours' after her poor attempts at remembering her lines without cue cards. ClientView also served to remind the author how bad her Australian accent is! However, it has all been worthwhile as the ultimate goal of replicating a real life interview seems to have been achieved. One student remarked, ClientView 'fits the Deakin mould of practically preparing students for life out of university, and short of live mock interviews this is the next best thing.'

Moss, 'The use of large-group role play techniques in social work education,' (2000) 19 *Social Work and Education* 471.

SHOULD THE INTERNATIONAL INCOME OF AN AUSTRALIAN RESIDENT BE TAXED ON A WORLDWIDE OR TERRITORIAL BASIS?

JOHN MCLAREN*

Many countries impose income tax on the worldwide income of their residents or citizens. This is the case in Australia where 'Australian residents for tax purposes' must pay income tax on their worldwide income including statutory income such as capital gains and dividends. If the government of a country adopts a 'worldwide' basis for imposing income tax on its residents then the existence of tax havens and offshore financial centres becomes an important issue because income from passive investments may not be disclosed and subsequently taxed in Australia. The Australian Government has recently funded 'Operation Wickenby', in an attempt to detect Australians using tax havens and reinforcing the integrity of a worldwide taxation system. This paper will start with a discussion of the philosophical basis for Australia having adopted a 'worldwide' system of taxation as opposed to a 'territorial system' and then examine the problems with collecting income tax on foreign sourced income generated by Australian residents. The paper will then draw a conclusion as to the merits of Australia adopting a territorial system for taxing foreign income and whether the worldwide system should be abandoned altogether.

I INTRODUCTION

As capital and labour become more mobile in a globalised world the ability of a government to tax income generated in a foreign country becomes one of the most important challenges of the twenty-first century.¹ Similarly, with the growth in technology and electronic commerce as well as the general effects of globalisation, it will be difficult for countries that have a worldwide system of taxation to collect taxes that should be paid by their residents on foreign sourced income.² This paper will discuss the effectiveness of the Australian government trying to impose income tax on the foreign sourced income of Australian residents under a worldwide system of taxation. The main question to be answered in this paper is whether it would be more equitable, efficient and with fewer complexities to simply impose income tax on income derived within Australia by Australian residents. In other words, should Australia adopt a pure territorial system for taxing foreign income or continue with the current arrangements? It should also be noted that no country uses a pure system of either worldwide or territorial taxation other than Hong Kong.³ Indeed, some commentators in this area of law have advocated the need to describe a worldwide system with deferral

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¹ Avi-Yonah, Reuven, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', (2000) 113 *Harvard Law Review* 1575, 1618.

² Tanzi, Vito, 'Globalization, Technological Developments, and the Work of Fiscal Termites', (2000-2001) 26 *Brooklyn Journal of International Law* 1261, 1262.

³ Wade, Claire, 'The President's Advisory Panel's Recommendation to Move from a Worldwide Tax to a Territorial Tax System', (2006) 12 *Law and Business Review of the Americas*, 373, 380.

for foreign sourced active business income as a 'hybrid worldwide' system and a territorial system that taxes some worldwide income as a 'hybrid exemption system'.⁴ On this basis of classification, Australia has a hybrid worldwide system. It is of interest to note that Australia did adopt a pure 'territorial system' of taxation between 1915 and 1930 and thereafter retained a modified system with exemptions and credits for foreign income.⁵

The remainder of this paper has been divided into five sections. Section II will look at the philosophical framework for taxing international income and in particular the sharing of tax revenue between nations. Section III of the paper will examine the advantages and disadvantages of a worldwide tax system using the criteria of equity, efficiency and simplicity to assess the current performance of the Australian taxation arrangements. Section IV of the paper will examine the rationale for adopting a territorial system and the advantages and disadvantages will be assessed within the framework of equity, efficiency and simplicity. The taxation system adopted in Hong Kong will be examined in detail and in particular the problem of trying to counter tax avoidance as a result of only imposing income tax on income sourced within the territory. Singapore will also be reviewed from an anti-tax avoidance perspective. Section V will examine measures that have been adopted in Australia and New Zealand to try to attract capital and labour. The introduction of these statutory measures would indicate that the Australian and New Zealand governments are prepared to adopt a territorial basis of not taxing foreign sourced income, as part of that taxpayer's worldwide income, in those circumstances. Section VI of the paper will provide a conclusion based on the analysis of a worldwide and a territorial system of taxation in order to assess what changes, if any, should be made to the current Australian taxation system.

II PHILOSOPHICAL FRAMEWORK FOR TAXING INTERNATIONAL INCOME

Prior to examining the specific attributes of a worldwide or territorial system for the taxation of international income, it is important to review the theory behind why countries have chosen one method of taxing international income over the other. The three recognised criteria, to be used as a framework for assessing the effects of the tax system on taxpayers, are the need for equity, efficiency and simplicity. These principles are based on the Adam Smith⁶ model of taxation, but are now regarded as the 'recognised cannons' of taxation.⁷ These principles of taxation were also recognised as being fundamental to the review of

⁴ Fleming, J. Clifton, Peroni, Robert and Shay, Stephen, 'Some perspectives from the United States on the worldwide taxation vs. territorial taxation debate', (2008) 3(2) *Journal of the Australasian Tax Teachers Association*, 35, 37.

⁵ Reinhardt, Sam and Steel, Lee, 'A Brief History of Australia's Tax System', Paper presented to the 22nd APEC Finance Ministers Technical Working Group Meeting, Vietnam, 15 June 2006.

⁶ Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, (1981).

⁷ Cooper, Graeme, 'An Optimal or Comprehensive Income Tax?', (1993-1994) 22 *Federal Law Review* 414, 421, footnotes 31, 32, 33 and 34. Graeme Cooper quotes from Smith, Adam, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, (1981). See also, Alley, Clinton and Bentley, Duncan, 'A Remodelling of Adam Smith's Tax Design Principles', (2005) 20 *Australian Tax Forum* 579, 586.

the Australian Tax System by the Asprey Committee⁸ and have since been used as a framework for the review of the Australian 'tax and transfer system' currently being conducted by the Australian Government.⁹ This framework will be used to assess the merits of taxing foreign income on a worldwide basis or a territorial basis. Fundamental to this analysis are the concepts of taxing international income at the 'source' of the income in the host country or in the country of the 'residence' of the taxpayer, the home country. It should be remembered that all countries tax income that has been derived 'within the geographic borders of the country levying the tax', namely the source of the income.¹⁰ In other words, income generated within any country will be subject to income tax even if derived by non-residents. However, in terms of describing an international tax system, the levying of income tax is based on taxation at the source of the income or on the basis of the residence of the taxpayer. Taxation at source is at the foundation of a territorial system of international taxation whereas taxation of international income based on the residence of the taxpayer is at the foundation of a worldwide system of taxation. However, in reality 'no country uses a pure worldwide or territorial system'.¹¹ The existence of the exemption of foreign active income from further taxation in Australia or the foreign tax credit for tax paid in the source country are aspects of a 'territorial' tax system.¹² These aspects of international taxation are explained in detail later in the paper.

Professor Peggy Musgrave discusses the sovereign right of the nation state to tax its residents on their worldwide income and contends that the right is recognised in international law.¹³ Musgrave states that the right to tax the income of residents and non-residents is based on the fact that a resident owes a tax allegiance in return for the rights and privileges which they receive as residents, giving rise to what is commonly referred to as the 'residence principle', and this is the reason why the country of residence has sovereignty over the total tax burden on the foreign-source income of its resident taxpayers.¹⁴

⁸ The Commonwealth of Australia, Taxation Review Committee, (1975) University of Sydney Library, Sydney (2001). The Committee was asked to consider the effects of the taxation system upon the economic and efficient use of resources in 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.' Chapter 3, 40. The three criteria were also used to evaluate the exemption and credit methods to provide relief against double taxation of international income, Chapter 17, 336.

⁹ Commonwealth of Australia, 'Architecture of Australia's tax and transfer system', (2008).

¹⁰ Kaufman, Nancy, 'Fairness and the Taxation of International Income', (1998) 29 *Law and Policy in International Business* 145, 146.

¹¹ 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), June 21, 2006, 2.

¹² The exemptions for active income, as opposed to passive income are found in sections 23AG, 23AH and 23AJ, *Income Tax Assessment Act 1936* (Cth), (ITAA 36) or the foreign tax credit, Division 770, *Income Tax Assessment Act 1997* (Cth), (ITAA 97). Division 770 applies from 1 July 2008 and now refers to the foreign tax credit as a 'foreign income tax offset'.

¹³ Musgrave, Peggy, 'Sovereignty, Entitlement, and Cooperation in International Taxation', (2000-2001) 26 *Brooklyn Journal of International Law* 1335, 1336.

¹⁴ Above n 13, 1337.

Professor Kaufman does not agree that a taxpayer's entire income necessarily needs to be taxed by a single country – the residence country.¹⁵ According to Kaufman, traditional international tax theory holds that a worldwide tax system based on residency and citizenship is grounded on the 'ability-to-pay theory' and source taxation, a territorial system, is based on a 'benefit theory'.¹⁶ Therefore, individual taxpayers with equal incomes should pay the same amount of tax no matter where the income is derived.¹⁷ The benefit theory holds that a non-resident should contribute to the host country's cost of government by being subject to tax at the source of the income.¹⁸ However, Kaufman rejects this view and contends that the 'ability to pay' and 'benefit theory' cannot explain the structure of the present international income tax system'.¹⁹ Horizontal and vertical equity is a national tax matter concerning taxpayers of the home country. The equitable sharing of taxes either based on source or residence is an international matter. As Kaufman states, equity in international taxation is an international matter.²⁰ Kaufman rejects the view that 'fairness in the international tax system necessitates the adoption of a worldwide tax base and that benefit theory underlies source taxation'.²¹

Inter-nation equity in international taxation is concerned about the sharing of tax revenue. If the host country imposes tax on income generated within its borders then the country of residence, by providing a credit for tax paid or an exemption from further tax on the income is foregoing revenue that it could have collected. Similarly, the host country may impose higher or lower taxes than those imposed in the home country on the resident taxpayer.²² It is this sharing of revenue on an equitable basis that is the foundation of international tax law. The justification for the imposition of taxes based on the ability to pay principle grounded in a worldwide system or the benefit theory grounded in a territorial system is what Kaufman argues is not correct, and that economic allegiance theory should be considered as a basis for inter-nation equity. In 1923, when the economic experts appointed by the League of Nations attempted to resolve the problem of sharing international taxation between two or more countries in order to eliminate double taxation, they considered the 'economic allegiance' theory for the sharing of taxes.²³

According to Kaufman, the League's economic experts considered economic allegiance to be the foundation of a nation's competence in taxation.²⁴ Kaufman concludes that there are three instances where the current international

¹⁵ Kaufman, Nancy, 'Equity Considerations in International Taxation', (2000-2001) 26 *Brooklyn Journal of International Law* 1465.

¹⁶ Kaufman, above n 15, 153.

¹⁷ Above n 15, 153.

¹⁸ Above n 15.

¹⁹ Above n 15, 202.

²⁰ Above n 15.

²¹ Above n 15, 203.

²² In Australia non-resident individuals are subject to higher marginal rates of personal income tax than are residents. This would appear to be at odds with a benefit theory for the imposition of tax at source because even though the non-resident receives little benefit from the host country, the host country imposes higher rates of tax.

²³ The four economic experts appointed by the League of Nations were Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp. The document produced was the '*Report on Double Taxation by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*', League of Nations (1923).

²⁴ Kaufman, above n 15, 196.

tax system provides evidence that the economic allegiance theory is at the foundation of the way in which nations share the tax revenue from international transactions. The first is the present international consensus on residence as the criterion for determining which country is the home country; second is the universality of source taxation despite the condemnation of income taxes based on benefit theory; and third, the foreign tax credit and exemption from tax for foreign source income are consistent with a view that the economic connection between the host country and the income arising there gives the host country its own interest in international income.²⁵ The same reasoning applies when applying a fairness test of 'ability to pay', because income derived out of the territory is not taken into account. This is why a territorial system is based on a 'benefits rule', in that the non-resident of the source country is levied on their source income on the basis that they have derived benefits from the host country.²⁶ Kaufman contends that source taxation, a territorial system, is out of favour with commentators because the 'ability-to-pay' theory has supplanted the 'benefit' theory.²⁷

It would appear that any discussion on inter-nation equity in international taxation is quite distinct from equity considerations at the national level. Commentators are divided over what is the correct philosophical basis for the sharing of tax revenue between the competing states. Philosophically worldwide taxation was grounded on a theory of ability to pay and territorial taxation was grounded on a benefit theory. Kaufman argues that an economic allegiance theory should be considered as the basis for inter-nation equity and the justification for the sharing of revenue based on a worldwide system and a territorial or source based system.

III WORLDWIDE SYSTEM - RESIDENCE TAXATION

Australia has adopted a worldwide system for the taxation of foreign income, but provides an exemption from income tax in Australia for some active business income that has been subject to tax at source and a credit against income tax to be paid in Australia for tax paid in the source country for passive income. In effect, this is a mixture of a worldwide and territorial system of taxation which prevents the double taxation of the income, first in the source country and then again in the country of residence of the taxpayer. DTAs prevent double taxation occurring in this situation. However, it is not intended to examine the history and details of DTAs in this paper other than to state that they are designed to eliminate double taxation and to allow for the exchange of information to prevent tax avoidance and evasion.²⁸

Australian residents pay income tax on their foreign ordinary income as well as their statutory income which includes capital gains. The taxing sections of the *Income Tax Assessment Act 1997 (Cth)*, (ITAA 97) are s 6-5 and s 6-10.²⁹ The

²⁵ Above n 15, 202.

²⁶ Above n 15, 183.

²⁷ Above n 15, 183.

²⁸ For an extensive discussion of the history of double taxation agreements and their future see the paper presented at the Australasian Tax Teachers Association Conference in Christchurch, New Zealand in January 2009 by C John Taylor, 'Twilight of the Neanderthals or are Bi-lateral Double Tax Treaty Networks Sustainable?'

²⁹ Sub-section 6-5(2) - If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia,

provisions relating to statutory income derived by residents and non-residents are very similar to the sections relating to ordinary income.³⁰

A Equity - Vertical, Horizontal and Inter-nation

Put simply, the concept of equity holds that the rich pay more in tax than the poor; vertical equity, and those on the same income pay the same amount in tax; horizontal equity. Over the past centuries different forms of taxation has been imposed on different sources of income and wealth, at different rates, and in some cases at higher rates for the wealthy than for the poor. One of the main aims of a tax system is to redistribute wealth from the rich to the poor, hence the concept of vertical equity. If tax is imposed at the same rate on the rich and poor alike, then it is considered to be contrary to vertical equity because it impacts on the poor to a greater extent than the rich. Therefore it can be seen that a progressive rate system is crucial in achieving vertical equity, namely that different rates of tax are imposed on different amounts of income. The Australian tax system adopts a progressive rate system for income tax and views vertical equity as being important for redistributive purposes.³¹

In terms of a worldwide tax system, vertical equity requires all taxpayers in Australia to pay income tax at different rates based on their total income and their 'ability to pay' in a progressive rate system. Unless foreign sourced income is included in assessable income then at least two inequitable consequences would follow; first the burden of tax would fall on those taxpayers unable to move capital offshore, and second; there would be an even greater incentive to earn foreign sourced income. This is one of the main reasons why a worldwide system is seen as being better than a territorial system, because with a territorial system foreign sourced income is not subject to income tax in the home state. What then is the situation with horizontal equity under a worldwide system? Horizontal equity requires all taxpayers earning the same level of income to pay the same amount of income tax. Proponents of a worldwide tax system contend that horizontal equity is safeguarded under that system because all taxpayers must include foreign income in their taxable income based on their residency, and pay the same rate of tax on that income.³² As well, horizontal equity is further enhanced because a system of foreign tax credits or exemptions ensures that the taxpayer does not pay more tax in their country of residence just because they include foreign sourced income.

during the income year. Sub-section 6-5(3) - If you are not an Australian resident, your assessable income includes: the ordinary income you derived directly or indirectly from all Australian sources during the income year.

³⁰ Sub-section 6-10(1) - Your assessable income also includes some amounts that are not ordinary income. Sub-section 6-10(2) - Amounts that are not ordinary income, but are included in your assessable income by provisions about assessable income, are called statutory income.

Sub-section 6-10(4) - If you are an Australian resident, your assessable income includes your statutory income from all sources, whether in or out of Australia. Sub-section 6-10(5) - If you are not an Australian resident, your assessable income includes your statutory income from all Australian sources.

³¹ Commonwealth of Australia, *Architecture of Australia's tax and transfer system*, (2008), 180.

³² 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), June 21, 2006, 3.

The issue of the source country imposing taxes on income generated by non-residents raises the concept of inter-nation equity. The country of source and the country of residence must agree on the share of taxes each country will claim. The source country is entitled to tax the income of the non-resident 'in line with the benefits provided by government services in generating that income'.³³ On this basis, the source country imposes a withholding tax on interest, dividends or royalties paid to a non-resident on their income from passive activities. An interesting example of differences with withholding tax rates is found in the exemption provided by the USA, UK and Australia with interest withholding tax for payments from Australia to banks in the UK and the USA.³⁴ Income from business activity is taxed at source on the basis of the non-resident having a 'permanent establishment' in that country and the income is subject to the higher rates of tax than the withholding tax rates. The standard of inter-nation equity is a responsibility of the source country whereas taxpayer equity is a responsibility of the residence country.³⁵

B Efficiency

The concept of capital neutrality is fundamental to having an international tax system that is efficient. The concept of 'neutrality' holds that the tax law should have no effect on behaviour and in this situation in relation to the choice of location where capital is to be invested. In order to achieve efficiency in international taxation, two types of neutrality are regarded as being crucial to that goal, capital export neutrality (CEN) and capital import neutrality (CIN).³⁶ Under an efficient international tax system CEN requires the taxpayer to be neutral about domestic or foreign investment because both should provide the same pre-tax rate of return. As Professor Michael Graetz states, 'economists regard CEN as essential for worldwide economic efficiency, because the location of investments will be unaffected by capital income taxes.'³⁷ For CEN to work, the country of source should not impose any source-based taxes, only the country of residence. The CEN concept has been adjusted in practice to allow for source based taxes but with a credit for those taxes being given in the country of residence.³⁸

This is similar to the current situation in Australia and many other OECD member countries that allow a credit for tax paid by their residents in the source country. It is usually passive income that is subject to a form of withholding tax at source, and a credit given for those taxes that have been paid.³⁹

The other type of neutrality is CIN, which 'requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor'.⁴⁰ According to Graetz, 'if CIN holds, all savers,

³³ Musgrave, Peggy, 'The Treatment of International Capital Income', in John Head (ed), *Taxation Issues of the 1980's* (1983), 279, 282.

³⁴ As a result of the Australia-USA free trade agreement, Australia exempted interest withholding tax of 10% when interest is to be paid to banks in the USA and UK.

³⁵ Musgrave, n 33, 281.

³⁶ Graetz, Michael, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies', (2000-2001) 54 *Tax Law Review* 261, 270.

³⁷ Above n 36, 270.

³⁸ Above n 36, 271.

³⁹ Division 770, ITAA 97.

⁴⁰ Above n 36, 270

regardless of their residence, receive the same after-tax returns'.⁴¹ CIN is said to support taxation only by the source country, with the country of residence exempting foreign source income from further taxation.⁴² This is the situation with active or business income being generated by an Australian resident in a foreign country with a full exemption being given for the income that has been subject to income tax at a comparable rate in the foreign country.⁴³ However, it should be remembered that the USA does not provide an exemption for active income generated by its own business residents in a foreign country that has been subject to income tax at source.⁴⁴

Graetz states that it is 'impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations'.⁴⁵ This means that governments must either choose a worldwide or territorial system for the taxation of foreign income in order to achieve efficiency in the tax system. Graetz uses the following three principles to illustrate the 'irreconcilable conflict between residence and sourced based taxation of income:

Principle 1: People should pay equal taxes on their income regardless of the country that is the source of that income. In particular U.S. taxpayers should be treated equally regardless of the source of their income.

Principle 2: All investments in the United States should face the same burden regardless of whether a U.S. person or foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

Principle 3: Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.

The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, tax bases, and choices between source-and residence-based taxation. That has never happened, and it never will. Moreover, there would be no way to keep such a system in place without violating Principle 3.⁴⁶

These principles outline the problem facing any government in trying to achieve equity in an international taxation system and at the same time trying to achieve efficiency. Both a residence and sourced based system have difficulty in achieving efficiency when most countries have different rates of income tax. The simple answer in deciding on the most efficient system to use is to adopt the system used in Australia, a hybrid system with a mixture of a worldwide and territorial system that allows for a credit for foreign taxes paid and an exemption from further income tax on the resident taxpayer for active income. In recent

⁴¹ Above n 36, 271.

⁴² Above n 36, 271.

⁴³ Sections 23AH and 23 AJ, ITAA 36.

⁴⁴ It should be noted that the USA does provide a limited exemption for individuals earning foreign sourced employment income. See Sheppard, Hale, 'Perpetuation of the Foreign Earned Income Exclusion: U.S. International Tax Policy, Political Reality, and the Necessity of Understanding How the Two Intertwine', (2004) 37 *Vanderbilt Journal of Transnational Law* 727, 731.

⁴⁵ Above n 36, 272.

⁴⁶ Above n 36, 272, footnote 36.

years many countries have adopted a hybrid exemption system and more than half of the OECD member countries have adopted such as system.⁴⁷

1. *Permanent Establishment – Active v. Passive Income*

Professor Reuven Avi-Yonah contends that in 1923 when the League of Nations was trying to resolve the problem of double taxation that it came to the conclusion that the ultimate goal underlying the international tax regime is that active business income is taxed in the source country in which it originates and that passive income should be taxed in the country in which the recipient resides.⁴⁸

This can be extended to reflect that income from investments should be subject to some limited form of taxation in the source country but greater tax in the home country, namely the country of residence. The distinction between passive and active business income is reflected in the double tax treaties by use of the permanent establishment concept. The basis on which income tax is imposed on non-resident business taxpayers is the concept of having a 'permanent establishment' (PE) in that country. The distinction between passive and active income by the use of a PE is a compromise, according to Avi-Yonah, because the threshold of what constitutes a PE is quite low: a single office, or even a single agent with authority to conclude sales, is generally sufficient.⁴⁹ Taxation of passive income in the country of source still exists but at very low rates of tax. The OECD Model Income Tax Treaty recommends that dividends be subject to withholding rates of tax of between 5 percent and 15 percent, interest at 10 percent and royalties 0 percent.⁵⁰ Avi-Yonah holds that the low tax rates imposed by the source country are a compromise between the source countries levying some tax but at the same time acknowledging that the country of residence should be the primary taxing authority.⁵¹

However, according to Graetz, the PE concept is 'facing new pressure from electronic commerce, new financial techniques, and new forms of business arrangements and combinations'.⁵² He strongly advocates a modernisation of the permanent concept possibly based on a threshold amount of sales, assets, labour or research and development within a nation.⁵³ The threat of reduced tax revenue from e-commerce was discussed by Professor Daniel Cheung when examining the challenges facing Hong Kong with its territorial tax system.⁵⁴ Because Hong Kong only taxes income based on its geography, e-commerce threatens future tax

⁴⁷ Fleming et al, n 4, 37.

⁴⁸ Avi-Yonah, Reuven, 'The Structure of International Taxation: A Proposal for Simplification', (1995-1996) 74 *Texas Law Review* 1301, 1306.

⁴⁹ Above n 48, 1307.

⁵⁰ Above n 48, 1308. In Australia the withholding rates are different depending on whether or not the dividends are carrying imputation credits, and if so, then the non-resident shareholder is subject to withholding tax to the extent the dividend is unfranked up to a maximum rate of tax of 15%. Interest is subject to 10% withholding tax unless paid to a 'bank' in the UK or USA and then 0% applies. Royalties are subject to 5% in the case of a US resident owner of the IP or 15% for any other non-resident.

⁵¹ Above n 48, 1308.

⁵² Graetz, Michael, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies', (2000-2001) 54 *Tax Law Review* 261, 319.

⁵³ Above n 52, 319.

⁵⁴ Cheung, Daniel, 'Debate on the Hong Kong Tax Base – Its Criteria, Principles, and Problems', (2001) 27 *International Tax Journal* 57, 76.

revenue to a far greater extent than a tax system based on the residence of the taxpayer.⁵⁵

2. *Active v. Passive Income – Exemption or Credit*

Australia already provides relief from double taxation in the form of exemptions of certain active income, s 23AG⁵⁶ for limited situations where personal services income is derived in a foreign country; s 23AH for branch income derived in certain foreign countries; and s 23AJ exempts non-portfolio dividend income paid by a foreign company. It is important to note that the USA does not provide an exemption for active business income for its resident companies, and this issue has become an important consideration for the US government, especially as US corporations are claiming that they are not as competitive as other MNEs.⁵⁷ If these exemptions already apply, why try to impose income tax on worldwide income and be concerned with Tax Havens? Australia also provides a credit for foreign tax paid on passive foreign sourced income so again in many instances no more income tax is paid in Australia.

A credit given by the home country for income tax paid in a foreign country is not as effective as the exemption method. Division 770 of the ITAA 97 applies from 1 July 2008 and now refers to the foreign tax credit as a 'foreign income tax offset'. Philip Bender has highlighted one of the potential defects of the new foreign tax credit arrangements: when active business income is repatriated to Australia that is exempt it carries no imputation credits from the foreign tax that has been paid. So, while the income is not subject to double taxation, it is subsequently taxed in the hands of the Australian resident shareholders when they receive a dividend.⁵⁸ The solution may be to only impose income tax on a territorial basis and not be concerned with income derived in foreign countries. Or the Australian government could adopt a derived and remitted system where only income remitted back to Australia is subject to income tax but this may act as a disincentive to repatriate profits to the home country.

3. *Anti-Deferral Measures - The Accruals System – the CFC, FIF and Transferor – Trust Provisions*

In 1991 Australia introduced anti-tax deferral legislation to impose income tax on Controlled Foreign Corporations (CFC's) and Foreign Investment Funds (FIF's) by 'attributing' to Australian taxpayers income perceived to have been generated in a tax haven or low taxing country. At the same time the Government introduced measures to prevent foreign trusts and foreign beneficiaries being used to avoid income tax in Australia. Those anti-avoidance and anti-deferral rules of taxation law have not worked well. As Professor Lee Burns states, the 'legislation enacting these regimes is among the most detailed and complex tax legislation in Australia. ... It is argued that the design does not

⁵⁵ Above n 54.

⁵⁶ Section 23AG was amended effective from 1 July 2009, Tax Laws Amendment (2009 Budget Measures No 1) Bill 2009, and only provides an exemption for relief workers and defence force personnel.

⁵⁷ USA, Joint Committee, Graetz and other commentators and organisations.

⁵⁸ Bender, Philip, 'Foreign tax credits and overseas investment: More reform necessary?' (2008) 37 *Australian Tax Review* 38, 61.

adequately take account of the nature of the global economy today.⁵⁹ If Australia adopted a territorial basis of taxation then these anti-avoidance provisions would not be required resulting in a reduction of complexity in the existing taxation law. The issue of the severe complexity of the Australian taxation law⁶⁰ and the urgent need for reform has been discussed above and the fact that one way in which complexity can be resolved is to adopt a territorial basis of taxation. Under a territorial system there is no need to have CFC, FIF and transferor-trust provisions as foreign sourced income would not be subject to income tax in the home country. The third criterion for determining an appropriate tax system is whether or not the laws and rules are simple to apply and administer and to be understood by taxpayers, both resident and non-resident taxpayers.

C Simplicity

According to Fleming et al, territorial systems are not simple, but are simpler than a worldwide system.⁶¹ Other commentators have also expressed the view that a territorial system is less complex than a worldwide system due largely to the anti-avoidance and anti-deferral measures contained in such a system.⁶² One simple way in which the existing taxation system in Australia could be made less complex would be to introduce a territorial basis of taxation.

A complex system is perceived to lead to tax evasion and tax avoidance because of the wealthy being able to obtain advice on how to take advantage of the complexities in the law.⁶³ The current review of the Australian tax system has noted that the income tax law contained in the various statutes is now 5,743 pages, up from 526 pages in 1975 when the 'Asprey'⁶⁴ report on the review of the tax system was produced.⁶⁵ The Business Council of Australia and the Corporate Tax Association released a report in 2007 on measures to reduce compliance costs on business and found that those businesses had to deal with 21 Australian Government taxes, 33 State taxes and 2 Local Government taxes. It was noted that this was more than twice the number of taxes effecting businesses in the United Kingdom.⁶⁶

D The Practical problems of detecting income in a tax haven

The Australian Government has recently funded 'Operation Wickenby', a multi-agency task force investigating tax avoidance and tax evasion involving the use of offshore entities. The task force comprises the Australian Taxation Office (ATO), the Australian Crime Commission (ACC) and the Australian Federal

⁵⁹ Burns, Lee 'Harmonization of the Anti-Deferral Regimes' (2007) July/August *Asia-Pacific Tax Bulletin* 269, 269.

⁶⁰ Wallis, David 'The tax complexity crisis' (2006) 35 *Australian Tax Review* 274, 274.

⁶¹ Fleming et al, n 4, 39.

⁶² Joint Committee on Taxation, n 17, 5.

⁶³ Fuest, Clemens, Peichl, Andreas and Schaefer, Thilo, Does a Simpler Income Tax Yield More Equity and Efficiency?, (2008) 54 *CESifo Economic Studies* 73, 73 and 74.

⁶⁴ The Report on 'Commonwealth Taxation Review Committee (Asprey Committee) (1975) looked at the Australian tax system in terms of equity, efficiency and simplicity as well as the need to broaden the tax base that existed in Australia at that time.

⁶⁵ Commonwealth of Australia, n 31, 305.

⁶⁶ Above n 65, 307.

Police (AFP). The budget for a five year period is around \$300 million and the Commissioner of Taxation estimates that the revenue recovered will be over \$300 million.⁶⁷ The 2009 Budget provided a further \$122 million over the next three years for 'Project Wickenby'.⁶⁸ According to the ATO, Project 'Wickenby' investigations have so far also resulted in:

- 23 criminal investigations
- 42 people charged on indictable offences
- 544 completed tax audits (and a further 716 underway)
- \$299.61 million in tax liabilities raised
- \$255.94 million in tax collected, assets restrained and compliance dividend.⁶⁹

If the ATO has not recovered in excess of \$420 million within the eight year period then the question will be asked, why go to this trouble and expense when the cost of recovery of income tax exceeds the amount of income tax actually recovered? The simple solution is to only impose income tax on income derived from sources in Australia by Australian residents and impose income tax on foreign income remitted to Australia by Australian residents. In addition, many countries including Australia are facing the problem of 'international tax arbitrage'. International tax arbitrage has been described by Professor Adam Rosenzweig as arising when a taxpayer can technically comply with the laws of two or more jurisdictions while at the same time reducing their total worldwide tax liability.⁷⁰ This is similar to situations that arise with countries that impose income tax on a territorial basis where a structure is used to derive income in another jurisdiction by artificial means so that it is not construed to have been derived in the home country. As a result of the fact that it is very difficult for the ATO to ascertain the existence of income being generated by Australian taxpayers in a tax haven or OFC, should the Australian Government therefore consider the merits of adopting the 'territorial approach' to the imposition of income tax on the foreign sourced income of Australian residents?⁷¹

IV TERRITORIAL SYSTEM - SOURCE TAXATION

Under a 'territorial system' of taxation, income tax is only imposed on income derived within the territory and this system is known as a pure 'territorial system' of taxation. Hong Kong is one of the few remaining countries with a territorial system and is the best example and it will be used throughout this section of the paper to illustrate the advantages and disadvantages of a territorial system of taxation. Up until 1 January 2001, South Africa also used a source

⁶⁷ Thomson ATP Weekly Tax bulletin, 23 February 2007, [285].

⁶⁸ D'Ascenzo, Michael, 'From the Commissioner's desk – we live in interesting times', (speech delivered at the National Institute of Accountants Public Practice Symposium, Sydney, 21 May 2009)

⁶⁹ Above n 68.

⁷⁰ Rosenzweig, Adam, 'Harnessing the costs of international arbitrage', (2007) 26 *Virginia Tax Review* 555, 557.

⁷¹ The territorial basis of imposing income tax is to only tax income sourced within the country or territory. This means that income generated by a resident taxpayer out of the territory is not subject to income tax in the home country. This is the situation in Hong Kong, Malaysia, Philippines and Singapore, Australia's nearest neighbours.

based system of income tax but changed to a worldwide system.⁷² The Minister of Finance, Trevor Manuel stated that a sourced based system was out of line with international practices and permitted tax avoidance by allowing income to be structured as 'foreign sourced' and that this was one of the main reasons for changing to a worldwide system.⁷³ Other countries including Singapore⁷⁴ and Malaysia have a hybrid territorial system which only imposes income tax on income that is sourced in their country and some categories of remitted foreign source income. This is commonly referred to as a 'derived and remittance' basis of a territorial system. Moreover, Australia, New Zealand and Canada had a territorial system of taxation up until the first few decades of the twentieth century due to the fact that the tax law was based on statutory law developed in the UK and applied in the colonies.⁷⁵

One of the major criticisms of those advocating a territorial system is that if a country that was currently using a worldwide system changed to a territorial system, then businesses and investment would move to a low or no tax country. There would be a flight of capital and business activity and with it employment and technology. A worldwide system is seen as protecting the residence country's tax base more effectively than a territorial system.⁷⁶ On the other hand a territorial system would make MNEs, currently a resident of say Australia, more competitive in a global environment because they would not need to worry about paying income tax on their foreign sourced income in situations where there is no exemption, either because it is passive income or the source country is not a listed country with comparable tax rates or no tax is paid to generate a tax credit. This is more important for companies resident in the U.S. where there is no exemption system, only a tax credit for foreign paid taxes.⁷⁷ Professor Robert Green claims that 'sourced based taxation is difficult to justify on theoretical grounds'.⁷⁸ Green makes this statement on the basis that it is hard to reconcile with an 'ability to pay theory' and the cost to government. Presumably he means that ability to pay and the benefits theory cannot be reconciled. There is no argument with that finding, but the Kaufman approach, as discussed above, based on the economic allegiance theory may provide a solution. Green then suggests that in order to prevent income shifting by MNEs and tax competition, an international acceptance of a worldwide system would be the best solution.⁷⁹ Fleming et al. does not advocate

⁷² Manuel, Trevor, Minister of Finance, Budget Speech, Republic of South Africa, 23 February 2000, www.finance.gov.za/ at 20 August 2009.

⁷³ Above n 72, 19.

⁷⁴ From 1 January 2003 Singapore has adopted a 'one tier system' for resident companies whereby all dividends paid to shareholders are exempt from tax and a partial exemption for foreign 'active' business income. See Ho, Kah Chuan, 'The Exemption Regime for Foreign-Source Business Income – An International Comparison', (2008) *Asia-Pacific Tax Bulletin* 118, 120. See also Halkyard, Andrew and Phua, Stephen, 'Common Law Heritage and Statutory Diversion – Taxation of Income in Singapore and Hong Kong', (2007) *Singapore Journal of Legal Studies* 1, 15.

⁷⁵ Littlewood, Michael, 'How Simple can Tax Law be?: The Instructive Case of Hong Kong', (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 259, 280.

⁷⁶ Joint Committee on Taxation, n 11, 4.

⁷⁷ Fleming et al, n 4, 39.

⁷⁸ Green, Robert, 'The future of Sourced-Based Taxation of the Income of Multinational Enterprises', (1993) 79 *Cornell Law Review* 18, 70.

⁷⁹ Above n 78, 70 and 86.

the adoption of a territorial system in the U.S. but suggest ways to remedy the defects in the U.S. worldwide system.⁸⁰

A Equity – Vertical and Horizontal

The major impact on equity within a territorial system is that taxpayers only pay income tax on their income generated within their own country of residence and their foreign income is not subject to income tax, other than taxes imposed by the source country such as withholding tax on passive income or normal taxes on active business income on the basis of having a PE. This means that the concept of horizontal equity has no meaning because not all taxpayers deriving the same income pay the same amount of income tax. Similarly, the imposition of progressive rates of tax, in order to achieve vertical equity, does not achieve a distributional effect because some taxpayers are only paying tax on a portion of their total income, namely income derived in their home country.

From an equity perspective, a territorial system fails to achieve either horizontal or vertical equity. This statement is reinforced by Dr Michael Littlewood when commenting on the Hong Kong taxation system. He contends that the tax system is inherently inequitable due to the rampant tax avoidance and evasion⁸¹ but with the poorest two-thirds of the workforce exempt from tax altogether, it is not necessary to try to ‘achieve equity among this part of the workforce’.⁸² In terms of the remaining third of taxpayers, Littlewood is of the view that the inequality is considerable, given the fact that under the Hong Kong tax system no income tax is paid on interest, offshore income and employee perquisites such as employer provided housing and motor vehicles.⁸³ However, according to Littlewood, people do not complain about the inequality due to the very low rates of tax, namely 16 percent.⁸⁴ However, given the extent of the poverty and deplorable living conditions for a substantial part of the population in Hong Kong,⁸⁵ the tax system is arguably failing to achieve vertical and horizontal equity by not collecting sufficient revenue from those with the ability to pay and providing the requisite level of welfare. In conclusion, a territorial system, as illustrated by the example of Hong Kong, clearly proves that a worldwide system satisfies vertical and horizontal equity better than a territorial system.

B Efficiency

It is in the area of efficiency that a territorial system, arguably, has substantial advantages over a worldwide system. A territorial system ‘treats all investment within a particular country, the source country, the same, regardless of the residence of the investor’.⁸⁶ This efficiency norm is referred to capital import neutrality, CIN, which is seen as favouring competitiveness between MNEs. In

⁸⁰ Fleming et al, n 4, 40.

⁸¹ Littlewood, Michael, ‘Taxation Without Representation: The History of Hong Kong’s Troubling Successful Tax System’, (2002) *British Tax Review* 212, 231.

⁸² Littlewood, above n 75, 287.

⁸³ Above n 75.

⁸⁴ Above n 75, 288.

⁸⁵ Littlewood, Michael, ‘The Legacy of UK Tax Law in Hong Kong’, (2008) 3 *British Tax Review* 253, 254.

⁸⁶ Joint Committee on Taxation, n 11, 5.

other words, source countries with a territorial system are indifferent as to the tax rates that apply in the capital importing country because that income will not be taxed in the source country. The investment decision is neutral from the perspective of the taxpayer in a territorial system and the government of that state. If the tax rates in the capital importing nation are lower than the home country then the taxpayer obtains the benefit. However, if the capital is imported to a low taxing country and the taxpayer is a resident of a country with a worldwide system, then the taxpayer obtains no advantage in taxation with their own home country. In the case of U.S. MNEs, they claim that they are at a competitive disadvantage because they are not able to claim an exemption from tax from their home country on tax paid at source, but merely a credit for tax paid at source. However, Australian MNEs do obtain the benefit of an exemption for active business income and non-portfolio dividends in some cases so they are not disadvantaged. In the situation with Australian MNEs exporting capital, they would hold that CIN is a measure of efficiency when investing in foreign countries because the home country provides an exemption or credit for tax paid. The Australian MNE is able to obtain the efficiency advantages because of the exemption from tax on active income that has the result of placing the MNE in the same position as that of an MNE in a territorial system home country.

Professor Paul McDaniel disagrees with the contention that from an efficiency perspective tax planning by lawyers and accountants is wasteful and that under a worldwide system the tax planning is more complex and hence more wasteful. His view is that sophisticated and complex tax planning to reduce the burden of tax would not change if the MNEs operated in a territorial system He contends that the U.S. tax culture is such that just as much effort would be exerted in reducing the tax burden in the U.S.A.⁸⁷

C Simplicity

A territorial system is seen as being less complex than a worldwide system because it does not need the anti-deferral regimes or the tax credit provisions which are 'two of the most complex features of a worldwide system'.⁸⁸ This contention has been totally rejected by Professor Paul McDaniel and he argues that the complexity in a worldwide system should also be present in a territorial system.⁸⁹ He contends that source of income rules; transfer pricing rules and the use of tax havens all impact on the complexity of taxation laws in a territorial tax system to the same extent as they do in a worldwide system.⁹⁰ It could be claimed that from an administrative perspective, a territorial system would not require vast amounts or money to be spent on trying to detect foreign income being derived by its residents and trying to obtain the cooperation of many nations in exchanging information about foreign investors. The perfect example of the resources required in tracking foreign investments by high-net-worth individuals or the activities of MNEs engaging in transfer pricing or profit shifting through interposed entities can be found in Australia with 'Operation Wickenby'.

⁸⁷ McDaniel, Paul, 'Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.?', (2006-2008) 8 *Florida Tax Review* 283, 291.

⁸⁸ Joint Committee on Taxation, n 11, 5.

⁸⁹ McDaniel, Paul, n 87, 291.

⁹⁰ Above n 89, 292-296.

However, tax avoidance and tax evasion is a problem for tax administrators in a territorial system in the same way it is in a worldwide system.

1. Tax avoidance and tax evasion

Using Hong Kong as the example of a pure territorial system, it is evident that tax avoidance and tax evasion occurs because income can be structured as being derived from a 'foreign source' and not from within the territory. In Hong Kong the Inland Revenue Ordinance contains an anti-avoidance rule which is based on the Australian and New Zealand rules.⁹¹ However, according to Littlewood the Hong Kong approach is unique as the law has also adopted the 'Ramsay Principle' as enunciated by the House of Lords in that case.⁹² The Ramsay principle is an approach to statutory interpretation based on the concept of 'fiscal nullity'.⁹³ In other words, transactions are entered into between parties where there is no commercial business effect other than to achieve an avoidance of tax. However, Hong Kong appears to have rarely used its few anti-avoidance rules in the same way as Australia and New Zealand have done, and as Littlewood states, the lack of the number of specific and general anti-avoidance rules has reduced the complexity of the tax law in that country.⁹⁴ The tax authorities in Singapore are facing the prospect of greater tax avoidance and tax evasion as a result of increasing their Goods and Services Tax to a rate of 7 percent, up from 3 percent. Halkyard and Phua contend that this increase will see a greater rise in the use of cash within the black economy.⁹⁵

2. Examples of territorial systems - Singapore, Hong Kong and Malaysia

The Singapore, the basis of levying income tax on the residents of Singapore is only on income derived in Singapore or income remitted to Singapore. The *Income Tax Act (Cap 134)* section 10(1) states that '[i] income tax shall ... be payable at the rate or rates specified ... for each year of assessment upon the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of - (a) gains or profits from business ... (b) gains or profits from employment; (c) dividends, interest or discounts ...'.

In Malaysia, the imposition of income tax on residents of Malaysia is similar to Singapore. The *Income Tax Act 1967 (Act 53)*, section 3 states that '... a tax to be known as income tax shall be charged each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia'. The Malaysian statute, Schedule 6, Part 1 contains a list of income which is exempt from income tax. The list specifically exempts the 'income of any person ... derived from sources outside Malaysia and received in Malaysia'.

⁹¹ Littlewood, Michael, 'The Legacy of UK Tax Law in Hong Kong', (2008) 3 *British Tax Review* 253, 267.

⁹² Above n 91, *WT Ramsay v IRC* [1982] AC 300.

⁹³ For a detailed discussion on this case and the concept of fiscal nullity see, Burgess, Philip, Cooper, Graeme, Krever, Richard, et al, *Cooper, Krever & Vann's Income Taxation Commentary and Materials* (6th ed, 2009), 1079.

⁹⁴ Littlewood, n 91, 268.

⁹⁵ Halkyard and Phua, n 74, 22.

In Hong Kong the Inland Revenue Ordinance (Chapter 112) imposes tax, under a scheduler system,⁹⁶ on rental income from property, section 5; on salaries from employment, section 8; and on business profits, section 14. In all of the three separate taxes, the key wording in the sections is that tax shall only be charged on property, salaries and profits 'situated in; arising in or derived from Hong Kong'. This means that there is no general tax on income, but rather a tax on three different kinds of income from specific activities.⁹⁷ The definition of 'profits arising in or derived from Hong Kong' is defined pursuant to section 2, as 'for the purposes of Part IV shall, ... include all profits from business transacted in Hong Kong, whether directly or through an agent'. The issue of determining the extent to which a profit 'has arisen or is derived from Hong Kong' has created a unique situation under the Hong Kong territorial tax system. Littlewood discusses this issue in detail and the fact that the current judicial interpretation of the statutory law is that a Hong Kong business must show that they have a branch, similar to a PE in another jurisdiction or they fall within a 'rare case' principle before the income can be said to have originated outside Hong Kong.⁹⁸

These three states do not need to have elaborate bureaucracies in place to try to ascertain the income of their residents that are derived in other countries such as tax havens. Moreover, the statutory law is contained in legislation that is a fraction of the size of the Australian Income Tax Assessment Acts, 1936 and 1997. However, these countries do have anti-avoidance rules but they do not have complex anti-deferral provisions similar to the CFC and FIF provisions used by Australia and other OECD member countries that tax on a worldwide basis.

V DEVELOPMENTS IN ATTRACTING CAPITAL AND LABOUR IN AUSTRALIA AND NEW ZEALAND

This section of the paper discusses two examples of relatively new changes to the taxation law in both Australia and New Zealand which adopt a 'territorial basis' of taxation for certain taxpayers living in either country. These two examples are included in this paper because they do support the overall contention that Australia could adopt a territorial system of taxation, as is the case with temporary residents in Australia or new migrants or returning New Zealand citizens to New Zealand.

A Taxation of Temporary Residents in Australia

Two very important changes to the existing income tax law have been introduced by the government that have very favourable implications for non-residents working in Australia or investing in Australia. Some commentators have gone so far as to suggest that Australia is now a confirmed 'tax haven' as a result of these changes.⁹⁹ The first change relates to 'temporary residents' that have

⁹⁶ A scheduler system of taxation imposes a different rate of tax, in some cases at progressive rates, on salaries, property and profits. In Australia the scheduler system was abolished in 1953 and was reintroduced for one year only in 1974.

⁹⁷ Littlewood, n 91, 258. If an individual elects to be assessed on their total income from all three schedules then in effect a general income tax operates.

⁹⁸ Above n 91, 266.

⁹⁹ Les Szekely, *IntaxMagazine*, October (2006) 3.

temporary visas for work purposes and how that impacts on their non-Australian sourced income. Under the law a temporary resident will only be liable to income tax on their Australian sourced employment or services income and not their worldwide income even though they live and work in Australia and may not be a resident of any other country for income tax purposes. This means that income generated from non-Australian sources, including capital gains, may not be subject to income tax anywhere, especially if they take advantage of a tax haven to hold their foreign capital and investments. There are no tax implications in Australia if the temporary resident remits all of the foreign source income to Australia for their use while living in Australia.

The second change in the tax law relates to non-residents and the narrowing of the range of assets that will be subject to income tax under the capital gains tax regime. The new law only imposes income tax on capital gains made from real property, or other assets being used in a business being conducted through a permanent establishment in Australia. The term 'permanent establishment'¹⁰⁰ takes its meaning from s 23AH, ITAA 36, where a Double Tax Agreement applies, or if no DTA, then the definition under s 6(1), ITAA 36.¹⁰¹ The definition of a permanent establishment referred to in s 23AH is the definition contained in the DTA which is based on the OECD Model. The definition in s 6(1), ITAA 36 is broader and more descriptive than the definition contained in the DTA.

B Temporary Residents – No Income Tax on Foreign Source Income

The law took effect from 1 July 2006 and is contained in Division 768, ITAA 97. 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. Generally foreign income derived by temporary residents is non-assessable non-exempt income and capital gains and losses they make are also disregarded for CGT purposes. There are some exceptions for employment-related income and capital gains on shares and rights acquired under employee share schemes. Temporary residents are also partly relieved of record-keeping obligations in relation to the controlled foreign company and foreign investment fund rules. Interest paid by temporary residents is not subject to withholding tax and may be non-assessable non-exempt income for a foreign resident.

Section 768-910 prescribes the way in which income derived by a non-resident is treated for income tax purposes. The following income is non-assessable non-exempt income (NANE):

- (a) the ordinary income you derive directly or indirectly from a source other than an Australian source if you are a temporary resident when you derive it;
- (b) your statutory income (other than a net capital gain) from a source other than an Australian source if you are a temporary resident when you derive it.

¹⁰⁰ 'Permanent establishment' is defined in the OECD Model Convention on Double Tax Agreements as 'a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, quarry or any other place of extraction of natural resources'.

¹⁰¹ Explanatory Memorandum, Tax Laws Amendment (2006 Measures No. 4) Bill 2006, 55.

This subsection has effect subject to subsections (3) and (5).

Section 768-915 provides that certain capital gains and capital losses of temporary resident are to be disregarded. Section 768-915 states that 'a capital gain or capital loss you make from a CGT event is disregarded if:

- (a) you are a temporary resident when, or immediately before, the CGT event happens; and
- (b) you would not make a capital gain or loss from the CGT event if you were a foreign resident when, or immediately before, the CGT event happens.'

C Who is a temporary resident?

The major question is who is a 'temporary resident' for the purposes of obtaining this tax concession? Section 995-1, ITAA 97 provides the definition of a 'temporary resident'. 'A person is a temporary resident if:

- (a) They hold a temporary visa granted under the Migration Act 1958; and
- (b) They are not an Australian resident within the meaning of the Social Security Act 1991; and
- (c) Their spouse is not an Australian resident within the meaning of the Social Security Act 1991.

However, they are not a temporary resident if they have been an Australian resident (within the meaning of this Act), and any of paragraphs (a), (b) and (c) are not satisfied, at any time after the commencement of this definition. The tests in paragraphs (b) and (c) are applied to ensure that holders of temporary visas who nonetheless have a significant connection with Australia are not treated as temporary residents for the purposes of this Act.'

This definition would therefore exclude any Australian citizen returning to Australia after having worked in a foreign country for a considerable length of time. This tax concession differs from the New Zealand tax concession in that New Zealand provides an incentive for New Zealand citizens to return to New Zealand if they have been away for more than 15 years. It is a missed opportunity for the government of Australia to provide an incentive for Australian citizens to return to Australia and to be able to bring their wealth and experience without paying income tax on their foreign earnings. If the former Australian resident had considerable wealth from foreign investments then they would not be able to take advantage of these provisions to avoid income tax on those investments, namely their worldwide income. However, for 'temporary residents' they are treated more like non-residents and the new tax concessions impose no income tax on foreign sourced income. This applies even if they have a controlled foreign corporation, CFC, or a foreign investment fund, FIF. The country that misses out on tax revenue is the home country of the temporary resident because all of their investments can be located in a tax haven where no income tax is paid.

D Non-Resident Investors - No Income Tax on Capital Gains

The *Taxation Laws Amendment (2006 Measures No.4) Act 2006* introduced new measures to overcome disincentives for foreign investors to invest in a range of non-real-property investments. The new provisions provide a definition of assets having the 'necessary connection with Australia' and instead

of nine categories the law simply uses the concept of 'taxable Australian property'. The Explanatory Memorandum states that the new law will narrow the range of assets that a foreign resident will be subject to income tax on their capital gain.¹⁰² Basically, only an interest in Australian real property, namely land and fixtures such as buildings and mining and quarrying interests that are not considered to be real property, and business assets of a 'permanent establishment' will be considered to have the necessary connection with Australia, s 885-15, ITAA 97. The law also provides elaborate tests to be used to prevent a non-resident investor using an interposed entity to hold real property and avoid income tax on any capital gain.

E Australia as a 'Tax Haven'

A temporary resident living in Australia and being regarded as a non-resident in their home country, can generate income from their foreign investments in any country including a tax haven, and pay no income tax on that income. Similarly, any capital gain generated through investment in Australian shares will not be included in the temporary resident's assessable income in Australia and effectively not taxed anywhere in the world. This situation fits within the classic definition of a 'tax haven' in that there are no or low effective tax rates being imposed on the temporary resident and in the case of capital gains on non-real property investments, the non-resident.

The OECD¹⁰³ has expressed concerns with its member countries having harmful preferential tax practices in order to attract investment and other 'financial and geographically mobile activities'.¹⁰⁴ One specific area that the OECD is concerned about is when a country 'ring fences' its own residents from taking advantage of taxation benefits that are only offered to foreign investors that are non-residents. The law in Australia which provides tax concessions for temporary residents and non-residents is not available to ordinary residents of Australia. They are being excluded from these benefits by a 'ring fence' and by definition; Australia is a tax haven according to the OECD guidelines.¹⁰⁵

The OECD contends that regimes that engage in 'ring fencing'¹⁰⁶ have a harmful effect on foreign tax bases. If the temporary resident of Australia is a non-resident of say the United Kingdom, then any capital gain generated from an investment in a third country, such as Vanuatu, will not be subject to income tax anywhere in the world. It is expressly excluded in Australia, not subject to income tax in the United Kingdom and not subject to income tax in the source country. For example, a temporary resident can generate income on investments in say Vanuatu, and pay no income tax on their world-wide income in Vanuatu, the United Kingdom or Australia.

Australia is now an attractive place to live as a temporary resident. According to Szekely, 'the tax law changes will not only attract the super rich but

¹⁰² Explanatory Memorandum, Taxation Laws Amendment (2006 Measures No.4) Bill 2006, 34.

¹⁰³ OECD, 'Harmful Tax Competition, An Emerging Global Issue', 1998 Paris, France.

¹⁰⁴ Above n 103, 7.

¹⁰⁵ Above n 103, 26.

¹⁰⁶ The term 'ring fencing' is used by the OECD to describe situations where the resident taxpayers are prevented from accessing tax benefits that are being provided to non-resident taxpayers. In effect the resident taxpayers are 'fenced in' and not allowed to enjoy the tax benefits being offered to foreign investors or businesses.

should assist in attracting the super talented'.¹⁰⁷ Large investment funds can be left in a tax haven and the income or capital gains generated will not be taxed in Australia and not in the temporary resident's home country. The temporary resident can even invest in say shares or units in a unit trust in Australia and not pay income tax on the capital gain generated from those assets in Australia as the new CGT rules for non-residents would apply as well. It would appear that the Australian Government is keen to attract very wealthy individuals from around the world to live in Australia as 'temporary residents' and bring their wealth with them. It will be interesting to see if the OECD has any comment to make about these very attractive tax concessions and whether or not it generates a tax war between other countries all trying to compete for wealthy individuals.

*F New Zealand and the Exemption for Transitional Residents*¹⁰⁸

The government of New Zealand was concerned about alleviating the extra tax costs for skilled labour working for the first time in New Zealand or New Zealanders who were returning after being away for more than 10 years.¹⁰⁹ As an incentive for new migrants to settle in New Zealand, or for New Zealanders to return to New Zealand, certain foreign income is exempt from taxation in New Zealand. Returning New Zealanders must have not been a tax resident at any time during the past 10 years prior to their arrival in New Zealand. The exemption from New Zealand tax on foreign income is for a period of four years or up to 49 months. The type of income that is exempt includes CFC and FIF income that would have been attributed under the New Zealand rules; income from foreign trusts; foreign dividends, foreign interest or royalties derived offshore; foreign rental income; income from employment performed overseas before coming to New Zealand such as bonus payments; gains on the sale of real property derived offshore; and offshore business income that is not related to the performance of services.

VI THREATS TO THE TAX BASE

It may not matter whether a country has a worldwide or territorial system for taxing the income of its residents as MNEs are able to take advantage of lower taxes in other countries by locating operations in different jurisdictions. Portfolio or passive capital and foreign direct investment by MNEs are increasing in their mobility. MNEs will continue to become larger and more powerful and their revenue sources and operations will lack any 'true residence'.¹¹⁰ Avi-Yonah discusses the U.S. trend towards a territorial system as the result of MNEs moving their head offices to low tax jurisdictions and the way in which those jurisdictions are lessening the impact of their CFC rules.¹¹¹ Avi-Yonah illustrates this point by

¹⁰⁷ Les Szekely, n 99, 3.

¹⁰⁸ The statutory law provisions providing the exemption from income tax for 'transitional residents' are contained in sections FC 22, FC 23 and FC 24, *Income Tax Act 2004* (NZ).

¹⁰⁹ Inland Revenue Department, 'Reducing tax barriers to international recruitment to New Zealand – a government discussion document', (2003), 3.

¹¹⁰ Noren, David, 'Commentary The U.S. National Interest in International Tax Policy', (2001) *Tax Law Review* 337, 340.

¹¹¹ Avi-Yonah, Reuven, 'Back to the Future? The Potential Revival of Territoriality', (2008) 88 *Working Paper, University of Michigan Law School*, 6.

showing that a third of the foreign profits of US-based multinationals are in countries with an effective tax rate of less than 10 percent. In 2003 when the data was gathered those countries were the Netherlands, Ireland and Bermuda. Avi-Yonah contends that the CFC rules and similar anti-deferral regimes need to be adopted and enforced by all OECD member states. However, he accepts that if MNEs are prepared to reincorporate in non-OECD countries then the OECD will need to do more to protect the corporate tax base.¹¹² This may be harder to do in practice as the current project to eliminate harmful tax competition has demonstrated.

The current situation with the flows of capital from one country to another is illustrated by the following example given by Graetz:

Luxemburg, for example, supplies almost as much direct investment to the United States as France and Canada, and the size of direct investment from the United States to Bermuda and Panama surely is not justified by economic considerations alone.¹¹³

Many commentators in this area of international taxation have pointed out the fact that the traditional tax base will be continue to be eroded as capital in the form of portfolio investment or direct investment is moved to low taxing countries. The global economic crisis may add to this problem as investor chase better after-tax returns on their investments.

VII CONCLUSION

In answer to the main question raised in this paper, whether Australia should adopt a territorial basis for taxing international income and abandon the worldwide system, it is contended that based on the available research in this area of taxation law that the current system that exists in Australia is perfectly adequate from the perspective of the three main criteria for assessing a tax system: namely equity, efficiency and simplicity. From the various views examined above, a territorial system of taxation is inherently inequitable from both a vertical and horizontal perspective. Based on the example of Hong Kong, Littlewood provides more an excellent overview of the existence of inequity in the current system. However, Hong Kong is unique and the fact that the taxpayers do not complain may just be indicative of the beneficial effects of having very low tax rates.

There is no evidence from the above analysis that a territorial system is more efficient than a worldwide system. Many of the commentators in this area are examining efficiency from the perspective of the U.S. system where the only benefit for U.S. MNEs is with a credit for foreign taxes that have been paid. This encourages the deferral of profit from being repatriated to the U.S. whereas a credit and exemption system, similar to that used in Australia and elsewhere, would arguably be better for U.S. companies competing internationally.

In terms of simplicity, the argument that a territorial system is simpler than a worldwide system is not conclusive. A territorial system still needs to have robust anti-avoidance rules, transfer pricing rules and laws that clearly distinguish between income sourced within the state and sourced in a foreign jurisdiction. The

¹¹² Above n 111, 13.

¹¹³ Graetz, Michael, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies', (2000-2001) 54 *Taxation Law Review* 261, 267.

example of Hong Kong used in this paper also illustrates the government's need to rely on anti-avoidance rules to safeguard revenue.

Australia does adopt both a worldwide and territorial system for the taxation of international income. Active business income, non-portfolio dividends and certain foreign employment income is exempt from taxation in Australia under the exemption mechanism. In other words, this type of income is not taxed on a worldwide basis. Passive income from investments is not subject to double taxation due to the existence of the credit mechanism that operates in Australia. Given this current situation, the only reason why the Australian Government would consider changing from a worldwide system to a pure territorial system is that in the global environment it is becoming very difficult to tax the income from mobile capital unless all nations co-operate on the disclosure of information on investments by non-residents in the host country. This raises questions about the effectiveness of the OECD measures in relation to 'harmful tax competition' and exchange of information agreements. It also raises questions about the effectiveness of 'Operation Wickenby' in Australia and the estimated income tax to be recovered. However, on balance there are strong arguments to leave the current hybrid worldwide system in place because it already incorporates many aspects of a territorial system, as discussed above.

The fact that the Australian and New Zealand governments introduced measures to put temporary residents and new migrants in a position where their foreign sourced income was not taxed in their home country can be explained as the two countries merely trying to compete globally for mobile capital and labour. It is contended that these measures should not be seen as a sign that a territorial system should replace the existing worldwide systems in at least Australia.

**THE DUTIES OF TAX COMMISSIONERS: THE SUSTAINABILITY OF THE
GENERAL JUDICIAL DENIAL OF TORTIOUS OR EQUITABLE DUTIES
TO AUSTRALIAN AND NEW ZEALAND TAXPAYERS**

JOHN BEVACQUA*

In both Australia and New Zealand the prevailing judicial view is that the duties of the Commissioner of Taxation and Commissioner of Inland Revenue respectively are owed exclusively to the Crown. Consequently, private law relief is usually denied to taxpayers making tortious or equitable claims against the relevant Commissioner. This article explores and confirms this judicial approach and questions its sustainability through assessing both the legal robustness of the judicial reasoning and the validity of the public policy concerns underlying the current judicial stance. It is concluded that the public policy grounds often relied upon in both countries are questionable. However, the New Zealand stance stems from a solid foundation of consistency with express legislative direction and close examination of recognised private law legal principles absent in the Australian decisions. Accordingly, while the approach in both countries is open to challenge, the Australian judicial approach is especially unsustainable.

I INTRODUCTION

There is no express statement in the *Taxation Administration Act 1953* (Cth) or any other Australian tax legislation directly addressing the question of to whom the Australian Commissioner owes his duties in carrying out his tax administration functions. Notwithstanding, Australian judges, in determining various private law claims by taxpayers against the Commissioner, have had little hesitation in asserting that the duties of the Australian Commissioner are owed exclusively to the Crown.

In contrast to the Australian position, New Zealand judges considering the issue of to whom the duties of the New Zealand Commissioner of Inland Revenue are owed have the benefit of at least some specific legislative guidance. For instance, section 6A(2) of the *Tax Administration Act 1994* relevantly provides:

In collecting the taxes committed to the Commissioner's charge...it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law...

On the strength of such legislative pronouncements, together with consideration of public policy concerns associated with protection of the revenue, the New Zealand judicial approach has also been to generally characterise the duties of the Commissioner of Inland Revenue as duties owed exclusively to the Crown.

The obvious implication is that the existence of private law duties in tort or equity will generally be denied to taxpayers aggrieved by acts or omissions of the Commissioner or his officers in both Australia and New Zealand. This article examines the sustainability of this restrictive approach to the question of tax commissioner duties in Australia and New Zealand.

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Specifically, Part II comprises a detailed exposition of the Australian and New Zealand judicial pronouncements in relation to the nature of the duties of the respective Commissioners and to whom those duties are owed. Judicial comments made in the context of considering claims in tort and equitable estoppel claims against the respective Commissioners are specifically highlighted. The consequent limitations on the availability of private law relief for taxpayers making claims against the Australian or New Zealand Tax Commissioner are confirmed.

Part III examines the sustainability of the general characterisation of the duties of both the Australian and New Zealand Commissioner as obligations owed exclusively to the Crown. Sustainability is measured in two ways. First, sustainability is measured in terms of the 'robustness' of the legal reasoning in the cases. This measure of sustainability encompasses assessments of the extent to which that reasoning is based upon any express legislative direction on the issue and the extent to which the reasoning is informed by considered discussion of existing private law legal principles. Second, sustainability is measured through an assessment of the validity of the core public policy justifications that also inform the general denial of any private law duties toward taxpayers.

The article concludes in Part IV with an assessment that the current denial of the existence of private law duties toward taxpayers in Australia is not sustainable either on legal robustness or public policy grounds. In contrast, the legal position in New Zealand stands up to challenge on legal robustness grounds. However, the reasoning in the New Zealand cases is equally open to challenge to the extent to which it is also informed by some of the same fragile public policy assumptions as the Australian judgments.

II THE DUTIES OF TAX COMMISSIONERS

A *The Australian Position*

There is no express statement in the *Taxation Administration Act 1953* (Cth) or any other Australian tax legislation directly addressing the question of to whom the Australian Commissioner owes his duties in carrying out his tax administration functions. Notwithstanding, Australian judges have had little hesitation in asserting that the duties of the Australian Commissioner are owed exclusively to the Crown. For example, in *Harris v Deputy Commissioner of Taxation*¹ ('*Harris*') Grove J asserted that:

[t]here is no basis upon which to conclude that there is a tort liability in the Australian Taxation Office or its named officers towards a taxpayer arising out of the lawful exercise of functions under the Income Tax Assessment Act.²

Such statements strongly suggest the existence of a broad, sweeping immunity from suit in negligence in favour of the Commissioner, grounded in an interpretation of the *Income Tax Assessment Act 1936* ('*ITAA36*') that implicitly accepts the lawfulness of negligent carrying out of *intra vires* functions by the Commissioner.

Harris is one of the few cases in which the tort of negligence has been asserted against the Australian Commissioner of Taxation.³ However, the Grove J

¹ (2001) 47 ATR 406.

² Above n 1, 408.

³ Negligence has never been successfully claimed against the Commissioner of Taxation in Australia. There are very limited reported cases in which negligence has been asserted and in none of these do the allegations appear to have been pursued to a full trial. For a detailed discussion of the prospects of a successful negligence claim against the Commissioner of Taxation see J Bevacqua, 'A Detailed

approach in *Harris* is not an aberration. His Honour's approach is broadly consistent with the approach taken in the equally rare cases involving allegations of tortious breach of statutory duty by plaintiff taxpayers against the Commissioner of Taxation.⁴ In *Lucas v O'Reilly*⁵ ('*Lucas*') Young CJ, in comprehensively rejecting the taxpayer's submissions, stated:

If the cause of action relied upon by the plaintiff is based upon a breach of statutory duty, the plaintiff must show...that the statute creating the duty confers upon him a right of action in respect of any breach...However, it is, I think, clear that the defendant owes the plaintiff no such duty. The duty of the Commissioner is owed to the Crown.⁶

According to the Young CJ reasoning, the Commissioner owes no duty to taxpayers whatsoever in his tax assessment function. The duty of the Commissioner is owed exclusively to the Crown. It follows logically from this stance that if no duty of care is owed to taxpayers according to Australian income tax legislation then the *intra vires* performance of the Commissioner's tax assessment functions negligently must be lawful. This is very similar to the stance taken by Grove J in *Harris*.

While the judgments of both Young CJ and Grove J are thin on detail,⁷ it is clear that common to both approaches to potential tortious liability of the Commissioner is an extreme judicial deference to an un-stated legislative intent in the Australian taxation laws to preclude the existence of a tortious duty of care owed by the Commissioner to taxpayers.

In equity too, a similarly restrictive stance to the availability of relief has been adopted in the Australian tax context. Unlike negligence and breach of statutory duty, both of which are largely judicially untested against the Commissioner of Taxation, estoppel has been tried with some limited success. However, in most cases alleging estoppel against the Commissioner of Taxation, the taxpayer has also failed.⁸ The

Assessment Of The Potential For A Successful Negligence Claim Against The Commissioner Of Taxation' (2008) 37 *Australian Tax Review* 241. The tort of negligence requires establishment of a duty of care owed by the plaintiff to the defendant and a breach of that duty by the defendant causing compensable loss resulting directly from the defendant's breach. Accordingly, the question of the Commissioner's duties will be of central relevance to determining whether a claim of negligence against the Commissioner could ever succeed.

⁴ Breach of statutory duty was also separately unsuccessfully pleaded by the taxpayer in *Harris v Deputy Commissioner of Taxation*, above n 1. Professor Luntz has summarised the elements of the tort of breach of statutory duty as follows: '[T]he plaintiff must prove the right to the performance of the statutory duty in question is enforceable by an action in tort; that the duty is imposed on the defendant; that the plaintiff is a person protected by the statutory duty; that the harm suffered by the plaintiff is within the class of risks at which the legislation is directed; that the defendant was in breach of the duty; and that the breach caused the harm for which the plaintiff seeks damages.' H Luntz, A Hambly, *Torts – Cases And Commentary* (3rd ed, 1992), 587.

⁵ (1979) 79 ATC 4081.

⁶ Above n 5, 4085.

⁷ Grove J does, at 409, express a view that proclamations such as the *Taxpayers' Charter* 'with express aims of treating citizens from whom tax is to be levied, fairly and reasonably' do not create any private law duties of care toward taxpayers. However, the question of statutory intent with respect to the duties of the Commissioner is not pursued further by his Honour. Similarly, Young CJ in *Lucas* does not expressly set out the basis for his confinement of the Commissioner's duties to the public sphere.

⁸ In the Australian context, Brennan J set out the requirements for demonstrating a sufficient claim of promissory estoppel in *Waltons Stores (Interstate) Ltd v Maher* (1990) 170 CLR 394, 428-429: 'In my opinion, to establish an equitable estoppel, it is necessary for a plaintiff to prove that (1) the plaintiff assumed or expected that a particular legal relationship exists between the plaintiff and the defendant or that a particular legal relationship will exist between them and, in the latter case, that the defendant is not free to withdraw from the expected legal relationship; (2) the defendant has induced the plaintiff to adopt the assumption or expectation; (3) the plaintiff acts or abstains from acting in reliance on the

general position in Australia regarding the prospects of estopping the Commissioner of Taxation was bluntly and concisely stated by Kitto J in *Federal Commissioner of Taxation v Wade* ('Wade'):⁹

No conduct on the part of the Commissioner could operate as an estoppel against the operation of the Act.¹⁰

Similar views, strongly suggestive of the extreme judicial sensitivity to encroaching on the public duties of the Commissioner, have been reiterated more recently in *AGC (Investments) Ltd v Federal Commissioner of Taxation* ('AGC')¹¹ by Hill J:

[T]here is no room for the doctrine of estoppel operating to preclude the Commissioner from pursuing his statutory duty to assess tax in accordance with law. The *Income Tax Assessment Act* imposes obligations on the Commissioner and creates public rights and duties, which the application of the doctrine of estoppel would thwart.¹²

Further comments about the public nature of the duties of the Australian Commissioner were made by Wallwork J in *Ellison v Deputy Federal Commissioner of Taxation* ('Ellison'),¹³ another recent case in which the plaintiff taxpayer was ultimately unsuccessful in raising an estoppel argument against the Commissioner:

In this case, there had been no reason for the Commissioner not to change his mind and to take action to protect the revenue which it was his public duty to protect.¹⁴

More general statements were made by the Victorian Supreme court in *Deputy Commissioner of Taxation v Tropitone Furniture Company Pty Ltd* ('Tropitone')¹⁵ Gobbo J in that case noted:

It seems to me that it is highly doubtful, having regard to well established principles, that save for well known exceptions, estoppel cannot [sic] lie against a statutory body charged with carrying out the performance of its duties.¹⁶

Consequently, the Commissioner has only been estopped in Australia in extraordinary cases in which the Commissioner has sought to resile from an explicit and clear commitment made to an individual taxpayer tantamount to a contractual

assumption or expectation; (4) the defendant knew or intended him to do so; (5) the plaintiff's action or inaction will occasion detriment if the assumption or expectation is not fulfilled; and (6) the defendant has failed to act to avoid that detriment whether by fulfilling the assumption or expectation or otherwise.'

⁹ (1951) 84 CLR 105.

¹⁰ Above n 9, 117.

¹¹ (1991) 91 ATC 4180.

¹² Above n 11, 4195. In relation to this case it was noted in *Bellinz Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 154, at 164, that: 'It was not suggested that the appellants could rely on estoppel, although the administrative law arguments advanced in reality seek to activate a doctrine of estoppel in a different guise.'

¹³ (1999) 99 ATC 4576.

¹⁴ Above n 13, 4584. The public nature of the duties of revenue authorities such as the Commissioner of Taxation was also affirmed in *BBLT Pty Ltd and Ors v Chief Commissioner of State Revenue (NSW)* 2003 ATC 5063, 5075, in which Gzell J, referring to the authority of *Wade* and *AGC*, held that: 'It should be noted, however, that with few exceptions the courts have concluded that estoppel does not lie against a fiscal authority on the basis that the authority cannot be prevented from carrying out the public duties cast upon it by the legislation.' Again the plaintiff's estoppel argument was unsuccessful.

¹⁵ (1991) 22 ATR 361.

¹⁶ Above n 15, 364.

commitment and raising no questions of limits on exercise of statutory powers or duties.¹⁷

The approach in cases such as *Wade*, *Ellison*, *Tropitone* and *AGC* indicates a sweeping rejection of the availability of an estoppel remedy in most tax Australian cases, again founded on an unexplored view that the Commissioner owes duties only of a public nature - to the Crown. The most interesting recent exception to this sweeping approach is the judgment of the Supreme Court of Queensland in *Federal Commissioner of Taxation v Winters*.¹⁸ Moynihan J, after discussing a number of the relevant authorities on the question of estoppel of public bodies, distinguished *AGC* and *Tropitone*, and asserted that '[i]n my view, depending of course on the resolution of factual issues in their favour, the defendants are capable of making out the elements founding an estoppel of the kind for which they contend.'¹⁹ Accordingly, the Commissioner's application for summary judgment against the plaintiff was rejected.

Implicit in the approach of Moynihan J is an approach to the duties of the Commissioner which is more consistent with the relatively small amount of Australian authority which recognises some broader duties of the Commissioner, beyond duties to the Crown. A prime example of this broader approach is the judgment of Isaacs J in *Moreau v FCT*.²⁰ His Honour observed in that case in respect of the duties of the Commissioner that: 'His function is to administer the Act with solitude for the Public Treasury and with fairness to the taxpayers.'²¹ (emphasis added).

Such views indicating the existence of a duty of fairness to taxpayers have been echoed more recently in the United Kingdom by Lord Scarman in *Inland Revenue Commissioners v National Federation of Self-Employed and Small Business Ltd*.²² His Lordship in that case stated that 'modern case law recognises a legal duty owed by the revenue to the general body of the taxpayers to treat taxpayers fairly.'²³ These views have been positively received in a number of Australian tax cases, although not expressly confirmed as correct.²⁴ However, none of these cases were pleaded in tort or equity. These cases considered the extent of the statutory protection from administrative law judicial review afforded to the Commissioner by section 177 of the *ITAA36*.

Section 177(1) provides that where the Commissioner produces a notice of assessment, that assessment will be conclusive evidence of the due making of the

¹⁷ Cases in which the taxpayer has been successful in having estoppel-like responsibilities imposed on the Commissioner of Taxation are: *Cox v Deputy Federal Commissioner of Land Tax (Tas)* (1914) 17 CLR 450; *Precision Polls Pty Ltd v FCT* (1992) 92 ATC 4549; *Queensland Trustees v Fowles* (1910) 12 CLR 111. For a detailed exposition of these cases see C Rider, 'Estoppel Of The Revenue: A Review Of Recent Developments' (1994) 23 *Australian Tax Review* 135.

¹⁸ (1997) 97 ATC 4967.

¹⁹ Above n 18, 4969.

²⁰ (1926) 39 CLR 65. That case involved an ultimately unsuccessful challenged by the taxpayer to the powers of the Commissioner to amend a number of Notices of Assessment of the affairs of the taxpayer after the expiration of three years from the date when the tax payable on the assessment was originally due and payable.

²¹ Above n 20, 67.

²² [1982] AC 617.

²³ Above n 22, 651.

²⁴ See, for example, *David Jones Finance and Investment Pty Ltd v Federal Commissioner of Taxation* (1990) 90 ATC 4730; *Darrell Lea v Commissioner of Taxation* (1996) 72 FCR 175; and *Bellinz v Federal Commissioner of Taxation* (1998) 39 ATR 198.

assessment and that the amount and details of that assessment are correct.²⁵ The position remains that, generally, judicial review of an assessment will be precluded by section 177(1) unless no assessment has been made, or an incomplete or tentative assessment is made, or there is evidence of bad faith or 'improper purpose.'²⁶ Accordingly, despite the limited support for Lord Scarman's approach in the administrative law cases, the overall general judicial approach to the interpretation of section 177(1) does not flag a shift toward narrowing the broad denial of any private law duties to taxpayers in Australia evident in cases such as *Harris, Lucas, Wade* and *AGC*. Private law duties can generally only arise in cases where the Commissioner has acted in bad faith or for improper purpose.²⁷

B *The New Zealand Position*

In contrast to Australia, in New Zealand there is some clearer legislative guidance with respect to the question of to whom the New Zealand Commissioner of Inland Revenue owes his duties in carrying out his tax administration functions. Aside from the general obligations on the Commissioner imposed by the *State Sector Act 1988*²⁸ and the *New Zealand Bill of Rights Act 1990*,²⁹ section 6A(3) of the *Tax Administration Act 1994*, for example, provides:

In collecting the taxes committed to the Commissioner's charge, and notwithstanding anything in the Inland Revenue Acts, it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law having regard to –

- (a) The resources available to the Commissioner; and
- (b) The importance of promoting compliance, especially voluntary compliance by all taxpayers with the Inland Revenue Acts; and
- (c) The compliance costs incurred by taxpayers.

The existence of this provision has led at least one commentator to conclude that:

The Commissioner is thus under a statutory duty to collect the highest revenue that is practicable. He or she cannot exercise a discretion to reduce a

²⁵ The section does preserve the rights of taxpayers to seek a review or appeal against the assessment using the procedures contained in Part IVC of the *Taxation Administration Act 1953* (Cth).

²⁶ The High Court considered the meaning of section 177(1) in *DFC of T v Richard Walter Pty Ltd* (1995) 183 CLR 168. That case considered a challenge to the validity of certain assessments issued by the Commissioner to the taxpayer based upon the argument that the assessments issued were tentative or were vitiated by bad faith or improper purpose by virtue of the fact that two taxpayers were assessed to tax in respect of the same income derived from the one source. That argument was unsuccessful. See K Wheelright, 'Taxpayers Rights In Australia' (1997) 7 *Revenue Law Journal* 226, 238-239 for a good summary of the judgment in this case.

²⁷ The issue of what constitutes a *bona fide* exercise of the assessment powers of the Commissioner was recently revisited by the Federal Court in *Futuris Corporation Ltd v Commissioner of Taxation* [2008] HCA 32.

²⁸ As Chief Executive of a Department, the Commissioner is subject to the duties imposed on all Chief Executives by the *State Sector Act 1988*. See, for instance, section 32 of that Act which lists the principal responsibilities of departmental Chief Executives. These extend to efficient, effective and economical management of the relevant department. Given these duties are not unique to the Commissioner, they will not be examined further in this article.

²⁹ Some of the rights contained in the *New Zealand Bill of Rights Act 1990* may have some relevance in the tax context, for example, the right to observance of the principles of natural justice in the determination of a person's interests, rights and obligations by a public authority set out in section 27. Given the confinement of this article to tax-specific obligations of the Commissioner, further examination of the *New Zealand Bill of Rights Act 1990* is beyond the scope of this Article.

taxpayer's liability unless there is specific statutory authority to do so. Estoppel cannot be raised against the Commissioner and an *intra vires* exercise of the assessment function is not amenable to judicial review.³⁰

The same author also noted that consequently 'the Commissioner is unable to exercise a discretion in favour of taxpayers on the ground of fairness.'³¹ In reaching this conclusion, the author appears to ignore the vagaries of the wording used in section 6A. Terms such as 'practicable within the law' and 'the importance of promoting compliance, especially voluntary compliance' arguably suggest that the Commissioner has some statutory leeway to consider taxpayer rights and tax-authority/taxpayer relations in administering New Zealand's tax laws.

Similarly, when considered in conjunction with section 6 of that same Act, an even more compelling case for consideration of taxpayer private law rights could be made. Section 6 imposes a duty 'on every officer of any government agency having responsibilities under this Act' to protect the integrity of the tax system. Subsection (2) clarifies:

Without limiting its meaning, the integrity of the tax system includes –

- (a) Taxpayer perceptions of that integrity; and
- (b) The rights of taxpayers to have their liability determined fairly, impartially, and according to law...'

While this section may not displace the primary duty of the Commissioner to the Crown to protect the revenue, it may indicate scope for individual standing to bring private law claims against the Commissioner in appropriate cases. Nevertheless, as the discussion which follows indicates, the judicial interpretation of section 6A has generally been consistent with a more restrictive interpretation and confinement of the Commissioners duties to duties owed to the Crown.

As in Australia, there are few New Zealand cases dealing with allegations of private law duties toward taxpayers, especially in tort. However, the question of any duty of care of the Commissioner toward New Zealand taxpayers received recent judicial attention in the New Zealand Court of Appeal in *Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* ('Ch'elle').³² Keane J in the High Court hearing of the matter³³ gave particularly detailed discussion of the relevant judicial principles in striking out the taxpayer's allegations of negligence and breach of statutory duty against the Commissioner. The Keane J stance and reasoning were expressly affirmed by the Court of Appeal.³⁴ The detailed observations of Keane J on the nature of the duties of the Commissioner are, therefore, worthy of close examination.

Keane J struck out the taxpayer's negligence claim on a number of grounds. First, it was rejected due to the absence of a sufficiently proximate relationship between taxpayer and Commissioner. Keane J observed:

A duty of care ... is not lightly to be superimposed within a wholly statutory context on a public officer...especially where economic loss only is at stake. In the single Commonwealth case of which I have been told, in which a revenue official has been asserted to be under a duty of care, that was unsuccessful: *City Centre Properties Inc v Canada* [1993] FCJ No. 1260.³⁵

³⁰ A Alston, 'Taxpayers' Rights In New Zealand' (1997) 7 *Revenue Law Journal* 211, 212.

³¹ Above n 30, 225.

³² [2007] NZCA 299.

³³ *Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2005] NZHC 190.

³⁴ Above n 32.

³⁵ Above n 33, para [85].

Such reasoning is suggestive of the influence of underlying floodgates/indeterminate liability public policy concerns in the denial of the recognition of the existence of a duty of care.³⁶ Also indicative of public policy influences, Keane J also rejected the plaintiff's claim on the basis of public policy 'chill factor'³⁷ concerns, affirming the views expressed in *Rolls Royce New Zealand Ltd v Carter Holt Harvey*³⁸ that: 'There is a legitimate public interest in regulatory bodies being free to perform their role without the chilling effect of undue vulnerability to actions for negligence.'³⁹

Further, according to Keane J, the taxpayer failed to demonstrate any reasonable reliance on the Commissioner or establish a sufficient causal link between the loss alleged and the Commissioner's acts toward the taxpayer.

However, the primary basis for the Keane J stance was the view that the Commissioner's duties are primarily of a public nature:

In a relationship which is, in its essence, that of creditor and debtor, and highly defined in every degree, did the Commissioner assume, or must he be deemed to have assumed, a duty of care to avoid acting to Ch'elle's detriment on which Ch'elle was entitled to rely? Everything, I think, points to the contrary. Taxes of whatever species are debts owed to the Crown; and the Commissioner's responsibility as the Crown's agent is to collect that revenue for public purposes.⁴⁰

Keane J paid significant attention to the specific New Zealand statutory scheme governing the Commissioner to substantiate this view. In particular, reference was made to section 6A of the *Tax Administration Act 1994*, the Commissioner's rights to amend assessments,⁴¹ the ability of taxpayers to challenge a Commissioner's assessment⁴² and the liability of the Commissioner to pay interest on moneys due but not paid.⁴³ Keane J characterized the combination of these provisions as creating an

³⁶ The indeterminate liability concern encapsulates the desire to avoid 'liability in an indeterminate amount for an indeterminate time to an indeterminate class' This is the oft-quoted summary of the indeterminacy issue by U.S. judge Cardozo J in *Ultramares Corp v Touche* 255 NY 170 (1931), 179. Legg has described the indeterminacy dilemma and its relevance to the duty of care question in the following terms: 'One of the driving forces behind rejecting the existence of a duty of care has been the fear that it may expose a defendant to an indeterminate liability. Indeterminacy refers to not finding a duty of care when the liability flowing from that duty cannot be realistically calculated. Whether the liability is indeterminate will be determined by looking at whether the defendant knew or ought to have known of the number of claims and the nature of those claims.' M Legg, 'Negligent Acts And Pure Economic Loss In The High Court' (2000) 12 *Insurance Law Journal* 1, 7. For Australian judicial comment on the issue see the comments of the High Court in *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act 1979* (1986) 162 CLR 340, especially at 353. The indeterminacy concern is discussed at length in Part III.

³⁷ This argument, also commonly referred to as a concern with 'over-defensiveness' in the exercise of public duties which might result from the imposition of private law liability on a statutory authority, is discussed at length in Part III.

³⁸ [2005] 1 NZLR 324.

³⁹ Above n 38, para [35].

⁴⁰ Above n 33, paras [89] – [90]. Keane J, in reaching this conclusion relied on the authority set down in *Cates v Commissioner of Inland Revenue* [1982] 1 NZLR 530. In that case, McMullin J observed, at paras [14] – [15] that tax 'is recovered as a debt to the Crown and ... the Commissioner is no more than the statutory agent of the Crown appointed to collect it.'

⁴¹ In accordance with sections 108B, 113 and 127 of the *Tax Administration Act 1994*.

⁴² As set out in section 27 of the *Income Tax Act 1976*.

⁴³ Pursuant to section 120A of the *Tax Administration Act 1994*.

‘intricate balance ... between efficacy, accountability and due process’⁴⁴ with which the imposition of a private law duty of care would be inconsistent.

Insofar as the taxpayer’s claim alleging breach of statutory duty by the Commissioner was concerned, Keane J, in striking out the taxpayer’s claim, again made reference to the specific statutory scheme governing the duties of the New Zealand Commissioner. Keane J concluded:

These conclusions as to negligence, extend also, and are equally fatal I consider, to Ch’elle’s nearly identical claim for breach of statutory duty because there too, once again, the statute said to be breached is determinative.⁴⁵

Keane J gave an exposition of the relevant principles for determining whether a case for breach of statutory duty can lie, including the critical requirement of Parliamentary intention to confer a private law remedy as well as public law duties in the relevant governing legislation. Keane J was unambiguous in his conclusions in relation to the Parliamentary intent evident in the New Zealand tax legislation:

The revenue statutes contain no such clear indication. Their purpose is to garner revenue by a fair process securing equality of arms between the taxpayer and the Commissioner and in the instances in which Ch’elle seeks a remedy, I see no room for any independent right to damages for breach of statutory duty; only for misfeasance in public office.⁴⁶

There is no contradictory authority in New Zealand with respect to the reasoning of Keane J in *Ch’elle* as confirmed by the Court of Appeal. Accordingly, unless and until some contradictory authority emerges, the duties of the Commissioner in New Zealand cannot be said to extend to any private law tortious duties of care beyond duties to avoid committing a misfeasance in public office.⁴⁷

In equity too, a similarly restrictive stance on the availability of relief has been adopted in New Zealand. An estoppel claim has never succeeded in New Zealand against the Commissioner of Inland Revenue.⁴⁸ In fact, the observations of the majority in *Commissioner of Inland Revenue v Lemmington Holdings Ltd* (*Lemmington*)⁴⁹ echo the views expressed in Australia in *Wade*.⁵⁰

It is his [the Commissioner’s] judgment that counts under the statutory scheme in all these situations and it is a judgment which must be exercised from time to time unfettered by any views that he may have previously expressed either

⁴⁴ Above n 33, para [96].

⁴⁵ Above n 33, para [114].

⁴⁶ Above n 33, para [116].

⁴⁷ The examination of the tort of misfeasance is beyond the scope of this article as liability rests upon the deliberate or ‘malicious’ intent of the tortfeasor constituting an abuse of office. Essentially, therefore, while strictly a private law remedy it has as much in common with public law it is has with tort. As Sadler has observed: ‘It is the only tort having its roots and applications within public law alone. It cannot apply in private law; the defendant must be a public officer and the misfeasance complained of must occur whilst the public officer is purporting to exercise the powers of his or her office.’ See R Sadler, ‘Liability For Misfeasance In Public Office’ (1992) 14 *Sydney Law Review* 137, 138-139. For a good general discussion of the principles underlying this tort see S Hannett, ‘Misfeasance In Public Office: The Principles’ (2005) 10 *Judicial Review* 227.

⁴⁸ The prospects of establishing an estoppel claim against any public authority in New Zealand are generally slim. For example, Wild J in *Challis v Destination Marlborough Trust Board Inc* [2003] 2 NZLR 107 categorically concluded, at para [105], that ‘estoppel has no place in modern public law, and I hold against the existence of this cause of action.’

⁴⁹ [1982] 1 NZLR 517.

⁵⁰ In fact, specific reference is made to *Wade* and a number of other cases from foreign jurisdictions at 522 of the judgment.

generally or in relation to a particular taxpayer or matter and unconstrained by an assessment he may have previously made...There is no room for estoppel in such a case.⁵¹

Notwithstanding such seemingly conclusive statements, the availability of an estoppel remedy against the New Zealand Commissioner cannot be disposed of without consideration of judicial statements in cases considering the application of the public law doctrine of legitimate expectations in judicial review cases.⁵² It is in these cases that estoppel-like arguments are usually raised against the Commissioner in New Zealand.⁵³ Accordingly, it is these cases that give the greatest insight into the potential availability of an estoppel action against the New Zealand Commissioner.

Tellingly, a claim based on legitimate expectation has never succeeded against the Commissioner. However, there is conflicting authority as to whether a claim founded on allegations of a breach of the doctrine of legitimate expectations could potentially lie against the Commissioner. Harrison J summarised the position in *Westpac Banking Corporation v The Commissioner of Inland Revenue* ('*Westpac*'):⁵⁴

On the one side is the negative view expressed by Richardson J: for himself and Woodhouse P in the majority in *Commissioner of Inland Revenue v Lemmington Holdings Ltd* [1982] 1 NZLR 517 (CA), and singularly in *Brierley Investments v Bouzaid* [1993] 3 NZLR 655 (CA) at 664. On the other side is the affirmative dicta of Casey J: *Brierley* at 670.⁵⁵

His Honour ultimately concludes that the possibility of a successful estoppel-like claim framed in terms of a breach of legitimate expectations by the Commissioner claim remains open: 'I am content to proceed on the premise that legitimate expectation may be available: *Commissioner of Inland Revenue v Ti Toki Cabarets (1989) Ltd* [2001] 1 NZLR 174.'⁵⁶

⁵¹ Above n 49, 522.

⁵² The modern doctrine of legitimate expectations has been defined in the following terms: 'A decision-maker exercising discretionary power in the area of public law may create a legitimate expectation on the part of a person affected by the exercise of that power as to the manner in which the power will be exercised. This may occur on the basis of a promise or representation about treatment made by the decision-maker. Typical examples are a policy statement issued by the decision-maker as to the procedures to be adopted before the power is exercised, or a specific assurance to a particular individual how its power will be used. It may also occur where the decision-maker has engaged in consistent past practice in conferring a benefit upon a person in the exercise of its discretionary powers.' P Sales and K Steyn, 'Legitimate Expectations In English Public Law: An Analysis' [2004] *Public Law* 564, 565-566.

⁵³ The close relationship between the two causes of action was recently elaborated by Harrison J in *Westpac Banking Corporation v The Commissioner of Inland Revenue* [2007] NZHC 1151. His Honour observed, at para [105], that: 'While much has been written, judicially and academically, upon the topic of legitimate expectation, it is largely a restatement of the core requirement that public authorities act fairly when exercising their powers. Its genesis lies in and remains closely aligned to the private law principles of estoppel. Such differences as have recently emerged are, on analysis, no more than conceptual variations adopted to accommodate the changing circumstances of public body activity and to retain the flexibility which is inherent in the High Court's supervisory jurisdiction.'

⁵⁴ Above n 53.

⁵⁵ Above n 53, para [107]. Casey J in *Brierley Investments v Bouzaid* [1993] 3 NZLR 655, 670, left the questions surrounding the possibility of a successful claim founded on allegations of breach of legitimate expectations by the Commissioner open 'until a case arises where they will be determinative.'

⁵⁶ Above n 53, para [108]. In *Commissioner of Inland Revenue v Ti Toki Cabarets (1989) Ltd* [2001] 1 NZLR 174, the Court of Appeal also left the question open, noting, at para [41], that: 'This case does not call for determination in any absolute way of whether judicial review on the ground of denial of legitimate expectations can ever be brought in tax matters.'

Nevertheless, the imposition of equitable estoppel obligations on the Commissioner is hindered by similar obstacles to those facing a claimant in tort. These common obstacles also stem from the duties owed by the Commissioner as judicially extrapolated from the New Zealand legislative regime. Sections 6 and 6A of the *Tax Administration Act 1994* feature prominently in the judicial discussion.⁵⁷ These provisions led to Richardson J observing in *Commissioner of Inland Revenue v New Zealand Wool Board*:⁵⁸

...[A]ny scope for invoking legitimate expectation is necessarily limited by the scheme and purpose of the income tax legislation. Legitimate expectation cannot frustrate an honest appraisal by the Commissioner of the income tax liability of the taxpayer by means of an assessment of that liability.⁵⁹

Expressing similar views, Harrison J in *Westpac* observed that '[t]he Commissioner cannot act in a manner incompatible with statutory powers which must be exercised to a specified end...'⁶⁰ Blanchard J in *Miller v Commissioner of Inland Revenue*⁶¹ went further, asserting that 'the Commissioner is under a duty to change his mind if he concludes his earlier view was wrong.'⁶²

Also militating against the establishment of estoppel-like duties in favour of an aggrieved taxpayer are the New Zealand binding ruling provisions.⁶³ As Harrison J observed in *Westpac*:

The binding ruling regime was established to provide a mechanism for a taxpayer to secure a positive commitment from the Commissioner on how the taxation law would apply to a particular transaction. In a case such as this, a ruling once obtained would operate as an estoppel against the Commissioner,⁶⁴

His Honour concluded in that case that the plaintiff's failure to avail itself of this right operated to negate any possible argument giving rise to a legitimate expectation.

The end result is that the prospect of mounting a successful estoppel claim against the Commissioner of Inland Revenue in New Zealand, framed in either purely

⁵⁷ The provisions have been collectively referred to as the 'care and management' provisions. They mirror section 1 of the English *Taxes Management Act 1970*. Section 6(2) refers expressly to 'care and management', relevantly providing that: 'The Commissioner is charged with the care and management of the taxes covered by the Inland Revenue Acts...' These provisions are also discussed by Harrison J in the context of disposing of the taxpayer's allegations of breach of the doctrine of legitimate expectations by the Commissioner in *Westpac*, above n 53. See, especially, at paras [42] – [44].

⁵⁸ (1999) 19 NZTC 15,476.

⁵⁹ Above n 58,492. The partial immunity from suit afforded to the Commissioner by section 27 of the *Income Tax Act 1976* in carrying out his tax assessment function is also noted in some of the cases as an indicator of the limited duties of the Commissioner. Section 27 provides: 'Except in proceedings on objection to an assessment under Part III of this Act, no assessment made by the Commissioner shall be disputed in any Court or in any proceedings...either on the ground that the person so assessed is not a taxpayer or on any other ground; and except as aforesaid, every such assessment and all the particulars thereof shall be conclusively deemed and taken to be correct, and the liability of the person so assessed shall be determined accordingly.' For a good discussion of the relevance of this section see the discussion by the majority in *Lemington*, above n 49, 522.

⁶⁰ Above n 53, 143.

⁶¹ (1993) 15 NZTC 10,187.

⁶² Above n 61, 10,203-10,204.

⁶³ Contained in Part 5A of the *Tax Administration Act 1994*.

⁶⁴ Above n 53, para [118]. This is similar to the argument mounted by the Commissioner in *Commissioner of Inland Revenue v Ti Toki Cabarets (1989) Ltd*, above n 56, paras [31] – [32] that '[a] strong inference can be derived from the enactment of this regime that Parliament intended that binding rulings would be the only way in which the Commissioner may be lawfully bound by previous conduct.'

equitable terms or in terms of the public law doctrine of legitimate expectations, is exceedingly slim. This is, similar to the rejection of tortious duties, largely due to the interpretation of key features of the New Zealand legislative tax scheme as precluding the existence of any equitable duty to taxpayers in the absence of evidence of unfairness constituting an abuse of power.⁶⁵ In this respect, the New Zealand position is very similar to the Australian stance.

III THE SUSTAINABILITY OF THE AUSTRALIAN AND NEW ZEALAND POSITIONS

The judicial confinement of the duties of the Australian and New Zealand Commissioners as duties owed exclusively to the Crown is not, *per se*, a problem, notwithstanding the apparent inconsistency with Diceyan principles of equality under the law between citizen and Crown which this stance creates.⁶⁶ It is not unusual for the tax function to be recognised as being somewhat special, warranting some additional protection for tax officials from private law suit.⁶⁷ The central question for the purposes of this article, however, is the sustainability of the current judicial confinement of the duties of the Australian and New Zealand Commissioners to the Crown, effectively blocking off the main avenues of tortious and equitable relief to taxpayers in all but the most unusual of circumstances.

To answer this question, two criteria have been chosen. First, will be an assessment of the consistency of the judicial approaches in both countries with the statutory tax framework in each country and the general legal principles governing the determination of tortious and equitable liability of public authorities generally. In this article, this criteria is referred to as 'legal robustness.' Second, to the extent to which Australian and New Zealand approaches rely, either expressly or implicitly, on public policy grounds, it is also appropriate to assess sustainability based on the sustainability of those public policy grounds in the tax context.

⁶⁵ This fact was noted by the majority in *Brierley Investments v Bouzaid*, above n 55, in specifically affirming the views of O'Loughlin J in the Australian case of *David Jones Finance and Investment Pty Ltd v Federal Commissioner of Taxation*, above n 24.

⁶⁶ Dicey pertinently refers to tax collectors in his description of the concept of the rule of law: '[E]very official, from the Prime Minister down to a constable or collector of taxes, is under the same responsibility for every act done without legal justification as any other citizen.' A Dicey, *The Law Of The Constitution* (1885), 178.

⁶⁷ For instance, it has been noted that: 'Some governmental functions (taxing, licensing, control and conservation of natural resources) are by their nature believed to be so qualitatively different as to require special protection from liability.' See Note, 'Separation Of Powers And The Discretionary Function Exception: Political Question In Tort Litigation Against The Government' (1971) 51 *Iowa Law Review* 930, 970. Some writers take a more cynical line as to why the tax commissioners should enjoy an extended immunity from suit. For instance, McCabe gives two reasons, noting that the Australian Commissioner enjoys a privileged position on the basis of 'the optimistic assumption that all statutory powers are, in fact, exercised by administrators in good faith' and 'the conviction voiced by some policy makers that the affluent, educated individuals who are thought to be the typical subjects of the Commissioner's powers...should not be entitled to claim the benefit of rights that were designed to protect the "simpler" folk who are likely to come into contact with the police.' See B McCabe, "The Investigatory Powers Of The Commissioner Under The Income Tax Assessment Act And Individual Rights" (1993) 3 *Revenue Law Journal* 1, 9.

A *Sustainability – Legal Robustness*

In the case of the tort of negligence, the scope of any duty of care of a public body in both Australia and New Zealand has historically been determined through application of a guiding principle or approach such as the ‘policy/operational dichotomy’⁶⁸ various proximity-based approaches⁶⁹ and, more recently in Australia, through the consideration of various public policy issues as part of an explicit preference for an ‘incremental approach’⁷⁰ to determining novel or difficult tortious actions. Each of these approaches require consideration and weighing up of a range of issues around the nature of the complained of activity, the relationship between the citizen and the relevant authority and the many public policy ramifications which might be relevant to the determination of the existence or otherwise of a duty of care.

In New Zealand, there is evidence of express consideration of at least some of these core principles in the tax context. For instance, as noted in Part II, Keane J in *Ch’elle*, in rejecting the existence of a duty of care in favour of the taxpayer, referred expressly to concerns around proximity and the related issue of reliance.⁷¹ Further, His Honour refers directly to the leading New Zealand case of *Takaro Properties v Rowling*.⁷² In contrast, there is, no evidence of similar express recourse to any such

⁶⁸ The policy/operational dichotomy was first expressly enunciated in Commonwealth courts by the UK House of Lords in *Anns v Merton London Borough Council* [1978] AC 728. In Australia, Mason J in *Sutherland Shire Council v Heyman* (1985) 157 CLR 424, 469, subsequently explained the distinction between policy and operational acts in the following terms: ‘The distinction between policy and operational factors is not easy to formulate, but the dividing line between them will be observed if we recognise that a public authority is under no duty of care in relation to decisions which involve or are dictated to by financial, economic, social or political factors or constraints...But it may be otherwise when the courts are called upon to apply a standard of care to action or inaction that is merely the product of administrative direction, expert or professional opinion, technical standards or general standards of reasonableness.’ The original source is usually credited as the case law concerning a similar test contained in the United States *Federal Tort Claims Act*, most notably applied in *Dalehite v United States* 346 US 15 (1953); *Indian Towing co v United States* 350 US 61 (1955); and, more recently, *United States v Gaubert* 499 US 315 (1991).

⁶⁹ This approach was first canvassed in Australian courts by Deane J in *Jaensch v Coffey* (1983) 155 CLR 549. For a good discussion of various proximity-based approaches to the question of public liability duty of care see P Vines, ‘The Needle In The Haystack: Principle In The Duty Of Care In Negligence’ (2000) 23(2) *University of New South Wales Law Journal* 35. The New Zealand Supreme Court recently considered the tortious liability of public bodies in New Zealand in *Couch v Attorney-General* [2008] 3 NZLR 725 (SC). In that case, the majority applied a proximity-based approach to deny the existence of a duty of care to the plaintiff. The reasoning applied was essentially the same as would have been applied had the defendant been a private individual rather than a public body. This approach has been criticised. See G McLay, ‘The New Zealand Supreme Court, The *Couch* Case And The Future Of Governmental Liability’ (2009) 17 *Torts Law Journal* 16.

⁷⁰ The current prevailing incremental approach was described by Brennan J in *Sutherland Shire Council v Heyman*, above n 68. In that case, at 481, Brennan J described the rationale for the incremental approach as follows: ‘It is preferable, in my view, that the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a prima facie duty of care restrained only by indefinable considerations which ought to negative, or to reduce or limit the scope of duty or the class of persons to whom it is owed.’

⁷¹ This concern with proximity principles would appear to be consistent with the views of the majority in the Supreme Court in the subsequent recent case of *Couch v Attorney-General*, above n 69, which disposed of the question of duty of care of a public authority primarily on proximity grounds.

⁷² [1987] 2 NZLR 700. *Ch’elle*, above n 33, para 79. *Takaro Properties v Rowling* signalled a shift in New Zealand away from policy/operational and proximity-based approaches to liability toward consideration of these factors as part of a broader matrix for determining the justiciability of a claim in negligence against public authorities – an approach which is broadly akin to the Australian incremental approach.

principle or approach in the Australian judgment of Grove J in *Harris*, aside from a passing acknowledgment of the incremental approach.⁷³ This is suggestive of a more legally robust approach to the issue in New Zealand than in Australia insofar as tortious duties are concerned. This suggestion is confirmed by the comparison of the judicial treatment of allegations of breach of statutory duty in both jurisdictions.

In Australia, Young CJ in *Lucas* deviates from the usual Australian judicial course in considering allegations of breach of statutory duty. His Honour does not engage in any of the usual search for statutory intent to create private law rights to recovery by the plaintiff or class to which the plaintiff belongs. Such a search typically underpins determinations of whether a claim alleging breach of statutory duty is sustainable against a public authority in both Australia and New Zealand.⁷⁴ The Young CJ approach also goes much further than the recently enacted Australian State and Territory *Civil Liability Acts* which apply a *Wednesbury*⁷⁵ unreasonableness test as the threshold for finding a public authority in breach of a statutory duty.⁷⁶ The New Zealand approach to the issue, as evidenced by the approach of Keane J in *Ch'elle*, is a stark contrast. As discussed in Part II, a substantial portion of his Honour's judgment is dedicated to discussion of statutory intent in the context of the New Zealand legislative tax scheme.

It is this approach to the determination of statutory intent which provides the greatest challenge to the legal robustness of the Australian approach when compared to the New Zealand approach to the question of Commissioner duties. As noted from the outset, New Zealand tax legislation is more explicit on the issues of duties of the Commissioner than the Australian legislative scheme. This means that Australian judges face a more challenging task in determining statutory intent with respect to the existence or otherwise of private law duties of the Commissioner.

In light of the absence of express legislative guidance in Australia, the approaches of Young CJ in *Lucas* and Grove J in *Harris* in response to this challenge

⁷³ Above n 1, 409, His Honour merely observes: 'In recent times the determination of the existence of a duty of care has been directed to be established by recognition of novel areas of duty on an incremental or case by case basis: *Perre v Appand Pty Limited* (1999) 198 CLR 180; *Crimmins v Stevedoring Industry Finance Committee* (1999) 200 CLR 1.'

⁷⁴ Central to any case of alleged breach of statutory duty is a search for legislative intent to create a civil cause of action for a breach of the relevant statutory duty. See Sir A Mason, 'Negligence And The Liability Of Public Authorities' (1998) 2 *Edinburgh Law Review* 3, for discussion of the requirements of the tort of breach of statutory duty in Australia. See also C Phegan, 'Breach Of Statutory Duty As A Remedy Against Public Authorities' (1974) 8 *University of Queensland Law Journal* 158. For a cross-jurisdictional discussion see K Stanton, P Skidmore, M Harris and J Wright, *Statutory Torts* (2003). The concern is obviously to ensure that no judicial interpretation is applied to the relevant statutory provision such that it would operate to engage the court in quasi-legislative activity by imputing the existence of a statutory duty not intended by the legislature to accompany the relevant provision.

⁷⁵ The name of the *Wednesbury* unreasonableness test is derived from *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223. The test was described by Hayne J in *Brodie v Singleton Shire Council* (2001) 206 CLR 512, 628 in the following terms: '...the test is whether the decision is so unreasonable that no reasonable decision-maker could have made it. What the *Wednesbury* test reflects is that the courts are not well placed to review decisions made by such bodies when, as is often the case, the decisions are made in light of conflicting pressures including political and financial pressures.'

⁷⁶ There is some uncertainty as to whether these State and Territory Acts apply to Commonwealth officers such as the Australian Commissioner of Taxation, compounded by the fact that the definition of 'public and other authorities' varies from jurisdiction to jurisdiction. See s 41 of the *Civil Liability Act 2002* (NSW) for an example of the broadest ambit of the term; cf s 34 of the *Civil Liability Act 2003* (Qld). However, the combined effect of the decisions in *Lucas*, above n 5, and *Harris*, above n 1, largely renders this a moot point in the tax context.

are easily contrasted with the generally accepted Australian approach. Mason J enunciated the preferred approach in *Sutherland Shire Council v Heyman*.⁷⁷

The better view has always been that, unless the statute manifests a contrary intention, a public authority which enters upon an exercise of statutory power may place itself in a relationship to members of the public which imports a common law duty to take care.⁷⁸

Stewart and Sunstein, writing in the American context have expressed similar views. These commentators are explicit in suggesting that the availability of a remedy to the plaintiff in cases of defective administrative activity in circumstances in which the relevant legislation is silent on the issue should not be inhibited:

When Congress is simply silent on the question of remedies for defective administrative performance, that silence cannot automatically be read to negate judicial authority to create such remedies...⁷⁹

Precisely the opposite approach is evident in the judgments of Grove J and Young CJ.

It is conceded that underlying the judicial stance taken in *Harris* and *Lucas* might be the view that, notwithstanding the absence of express direct legislative guidance, the statutory limitations on the availability of various avenues of relief contained in the Australian tax legislation can be viewed collectively as indicative of a Parliamentary intent in Australia to create a 'comprehensive code' in the taxation field to the exclusion of civil law tortious liability. As discussed in Part II, section 177 of the *ITAA36* is an example of a legislative protection from suit specifically afforded to the Commissioner in Australia. There are numerous other statutory limitations on the availability of various avenues of relief similar to the restriction on judicial review contained in section 177 of the *ITAA36*.⁸⁰ Accordingly, a reasonable argument could be mounted along these 'comprehensive code' lines.⁸¹

⁷⁷ Above n 68.

⁷⁸ Above n 68, 459.

⁷⁹ R Stewart and C Sunstein, "Public Programs And Private Rights" (1982) 95 *Harvard Law Review* 1195, 1317. In contrast, Davies in M Davies, "Common Law Liability Of Statutory Authorities" (1997) 27 *University of Western Australia Law Review* 21 asserts, at 23: '...statutes usually define the body's functions, confer powers upon it, create decision-making structure for it, then leave it to the body itself to decide how best to use the powers to perform the functions with the available resources. That being so, it is arguable that the courts should not intervene to impose a common law duty to exercise the body's statutory power. If Parliament did not see fit to impose a duty by statute, why should the courts do otherwise? How can a statutory power be the source of a common law liability?'

⁸⁰ For example, Schedule 1 paragraph (e) of the *Administrative Decisions (Judicial Review) Act 1977* (Cth) exempts from review decisions forming part of the process of making of, leading up to the making of, or refusing to amend, an assessment of tax. For a detailed discussion of the scope and justifiability of the Schedule 1(e) exemptions see V Morabito and S Barkoczy, 'Restricting The Judicial Review Of Income Tax Assessments – The Scope And Purpose Of Schedule 1(e) Of The *Administrative Decisions (Judicial Review) Act 1977* (Cth)' (1999) 21 *Sydney Law Review* 36. A further example is the system of binding Public and Private Rulings contained in Divisions 357-361 of the *Taxation Administration Act 1953* (Cth) which could be construed as establishing a comprehensive approach to dealing with when the Commissioner will be bound to representations made to taxpayers. The current system following the enactment of the *Taxation Laws Amendment (Improvements to Self Assessment) Act (No 2) 2005* (Cth) is explained by the Commissioner in two recent Rulings in *TR 2006/10* in relation to Public Rulings and *TR 2006/11* in relation to Private Rulings.

⁸¹ There is Canadian authority for the application of such an approach in an equitable claim alleging unjust enrichment against the Canadian revenue, albeit in the context of discussion of the ability to raise an unjust enrichment claim in cases of non-compliance with statutory time frames set out in tax legislation. See *British Columbia Ferry Corp v MNR* 2001 FCA 146; [2001] 4 FC 3. See also the discussion of this case by Beninger in M Beninger (ed), *Taxpayer Rights: Emerging Legal Techniques*, Canadian Tax Foundation Conference (2000), at para 10.8.

The problem though, insofar as the legal robustness of the Australian approach is concerned, is that the judgments of Young CJ and Grove J make no mention whatsoever of reliance on any such reasoning. Even if considered plausible, any such argument warrants express judicial consideration before acceptance in order to be considered a legally robust foundation for rejecting the existence of private law duties of the Australian Commissioner.⁸²

Again, the New Zealand approach provides a contrast. As noted in Part II, Keane J in *Ch'elle* gave an exposition of the relevant principles for determining whether a case for breach of statutory duty can lie, including the critical requirement of Parliamentary intention to confer private law rights as well as public law duties in the relevant governing legislation. Further, Keane J in *Ch'elle* was unambiguous in his conclusions in relation to the Parliamentary intent evident in the New Zealand tax legislation.⁸³

These facts alone place the Keane J approach on a sturdier footing than the Australian judgments. In addition, insofar as Keane J in *Ch'elle* sought to rely on the 'comprehensive code' argument, speculated as possibly underpinning the Australian approach, His Honour expressly discussed the broad New Zealand legislative regime before concluding, as noted in Part II, that the combination of the various provisions served to create an 'intricate balance ... between efficacy, accountability and due process'⁸⁴ with which the imposition of a private law duty of care would be inconsistent. Again, therefore, the New Zealand approach stands on a more legally robust footing than the ultimately almost identical Australian judicial conclusion.

In equity too, there is evidence that the approach adopted in estoppel cases against the Australian Commissioner of Taxation in cases such as *Wade, Tropitone, Ellison* and *AGC* is open to challenge on legal robustness grounds as differing from the approach usually adopted in estoppel cases against other Australian public bodies. The confinement of the extent of any equitable duties in such cases in Australia is usually determined in the context of consideration of whether the imposition of liability would offend the 'non-fetter' principle. This is the principle that 'government should not be shackled in exercising its power to make decisions in the public interest in the future.'⁸⁵ In the estoppel context this translates into a principle known as the *Southend-on-Sea* principle 'that an estoppel may not be raised to prevent the performance of a statutory duty or to hinder the exercise of a statutory discretion.'⁸⁶

⁸² This would allow challenges to such an approach to be addressed and countered if necessary. For example, a possible challenge to this kind of approach might be that such an interpretation of statutory intent might lend to the relevant provisions a meaning that goes beyond any proportionate or appropriate intended purpose of those provisions. A similar argument was successful in *Nationwide News Pty Ltd v Wills* (1992) 177 CLR 1. In that case, the Australian High Court held invalid a provision of the *Industrial Relations Act 1988* which purported to exclude the defences of justification or fair comment being available in instances of criticism of the Industrial Relations Commission. For a detailed discussion see L Busch, "Standards Of Review Of Administrative Decision-Making And The Role Of Deference In Australian Public Law" (2006) 11 *Judicial Review* 363, especially at 365-367.

⁸³ See the comments of His Honour at para [116] of the judgment as reproduced above at n 46.

⁸⁴ Above n 33, para [96].

⁸⁵ M Allars, 'Tort And Equity Claims Against The State' in PD Finn (ed), *Essays On Law And Government* (1996) vol 2, 49, 86. For further enlightening discussion of the non-fetter principle see C Hilson, "Policies, The Non-Fetter Principle And The Principle Of Substantive Legitimate Expectations: Between A Rock And A Hard Place?" (2006) 11 *Judicial Review* 289; C Hilson, 'Judicial Review, Policies And The Fettering Of Discretion' [2002] *Public Law* 11; and G Pagone, 'Estoppel In Public Law: Theory, Fact And Fiction' (1984) 7 *University of New South Wales Law Journal* 267.

⁸⁶ M Allars, *ibid* at 86. The *Southend-On-Sea* principle derives its name from the case of *Southend-On-Sea Corp v Hodgson (Wickford) Ltd* [1962] 1 QB 416.

There is no express discussion of such principles in estoppel cases involving the Australian Commissioner such as *Wade*, *Tropitone*, *Ellison* and *AGC*.

The typical approach to estoppel claims against public authorities such as the Commissioner also presupposes a weighing up of competing public interests where public and private interests might conflict, prior to any conclusion being reached as to the public or private nature of the duties created by a particular statute. For example, in *Commonwealth v Verwayen* ('*Verwayen*'),⁸⁷ arguably the leading Australian authority on the application of promissory estoppel principles against the Crown, a significant portion of each of the judgments of the members of the High Court is dedicated to a close examination of the statutory intent, meaning and duties created by the relevant section of the *Limitation of Actions Act 1958* (Vic) upon which the Commonwealth was seeking to rely to deny the possibility of the plaintiff bringing his action out of time, contrary to earlier representations not to do so. While it is probable that a similar examination of the relevant provisions of the *Income Tax Assessment Acts* would result in the conclusion that those provisions are 'not for the benefit of any individuals or body of individuals, but for considerations of State'⁸⁸ no such analysis is entered into in the relevant Australian tax cases to date.⁸⁹

In contrast, as discussed in Part II, numerous express references to concerns with fettering the Commissioner through the imposition of estoppel-like duties are made in the New Zealand cases addressing the issue. For example, the majority in *Lemington* expressly refer to the non-fetter principle as precluding the availability of estoppel relief against the Commissioner of Inland Revenue.⁹⁰

Most pertinently, though, it is the detailed discussion of Parliamentary intent and the accompanying weighing up of public and private interests in the New Zealand cases which distinguishes those cases from the Australian approach. In Part II a number of examples were noted including, again, the comments of the majority in *Lemington*⁹¹ as well as the comments of Harrison J in *Westpac*,⁹² Blanchard J in *Miller v Commissioner of Inland Revenue*,⁹³ and Richardson J in *Commissioner of Inland Revenue v New Zealand Wool Board*.⁹⁴

It is conceded that the express legislative attention to the duties of the Commissioner evident in New Zealand in sections such as sections 6 and 6A of the *Tax Administration Act 1994* arguably give rise to an unavoidable judicial need to discuss the question of Parliamentary intent directly in New Zealand in a manner that the relative legislative silence in Australia does not. Notwithstanding, arguably, the legislative silence in Australia could be said to give rise to an even greater obligation on Australian judges to explore the weighing up of public and private interests in

⁸⁷ (1990) 170 CLR 394. In contrast to the approach in the tax cases, in that case Mason CJ concluded, at 417, albeit after expressing reservations about holding the Commonwealth to its representations, thereby depriving it of defences which were available to it by statute or the general law, that – 'It was not argued that any special rule of estoppel applies to assumptions induced by government, either so as to expand or so as to contract the field of operation of the doctrine.'

⁸⁸ *Admiralty Commissioners v Valverda (Owners)* (1938) AC 173, 185. This test was cited by Mason CJ in *Verwayen*, above n 87, as central to determining whether the relevant statutory provision is capable of being waived (and, consequently, also capable of forming the basis for an estoppel action).

⁸⁹ The notable exception is the judgment of Moynihan J in *Winters*, above n 18, in which *Verwayen*, above n 87, and other leading cases are, at least, expressly considered.

⁹⁰ See the comments reproduced above n 51.

⁹¹ Reproduced above n 49.

⁹² Reproduced above n 60 and n 64.

⁹³ Reproduced above n 62.

⁹⁴ Reproduced above n 59.

estoppel claims against the Commissioner in order to reach legally defensible conclusions as to the Australian Commissioner's private law duties to taxpayers.

B *Sustainability – Public Policy Foundations*

While the preceding discussion suggests that the current New Zealand approach to determination of the question of to whom tax commissioners owes their duties might stand out as more legally robust than the Australian approach to the question, it remains the case that the approaches taken in both countries may not be sustainable insofar as they are founded on a number of core public policy concerns. It will be recalled, for instance, that Keane J made express reference to 'chill factor' concerns in *Ch'elle* and indirect reference to indeterminacy/floodgates concerns in raising proximity concerns related to the pure economic loss nature of the taxpayer's claim in that same case. Further, in both Australia and New Zealand the judicial deference to legislative intent (stated or unstated) evident in the cases is also suggestive of separation of powers/judicial competency public policy concerns. Accordingly, the sustainability of the current Australian and New Zealand approaches to the issue cannot be comprehensively addressed without examining the legitimacy of these three core public policy concerns in the tax context. Accordingly, the viability of each of these concerns as a sufficient basis for sustaining the continuing judicial denial of the existence of any private law duties of the Australian and New Zealand Commissioners is considered, in turn, below:

1. *Chill factor effects*

The nub of the 'chill factor' / over-deterrence argument is that imposition of private law duties on public authorities may result in a redistribution of resources away from high risk (but potentially socially beneficial activities) and toward lower risk activities. In the context of the tax administration function, the issue is often flagged to warn of the possibility that important high risk activities such as the provision of tax information or advice to taxpayers might be scaled down in favour of lower risk activities.⁹⁵

The main challenge to these concerns is the general absence of empirical evidence to confirm or challenge the existence and/or extent of any chilling or over-deterrent effect on public authority activities. In fact, there is very little empirical evidence at all.⁹⁶ Certainly, there is no empirical evidence which specifically assesses the chill factor/over-defensiveness phenomenon in the tax administration context.

⁹⁵ This potential argument is most comprehensively explored in literature considering equitable estoppel claims against the Commissioner of Taxation. Estoppel actions often arise out of representations made by officials where they are under no statutory duty to assist. The fear is that applying estoppel principles in such circumstances might lead to no such assistance being given in future. For a comprehensive discussion of the issues in the taxation context see, C Rider, above n 17. For a comprehensive rebuttal of 'chill factor' concerns in the estoppel context see D Knight, *Estoppel (Principles?) In Public Law: The Substantive Protection Of Legitimate Expectations*, University of British Columbia, (2004), especially at 145.

⁹⁶ This fact is lamented by the UK Law Commission in a 2004 report – See UK Law Commission, Public Law Team, *Monetary Remedies in Public Law: A Discussion Paper* (2004), especially at paras [7.10]-[7.11]. Writers such as Markensius, Fairgrieve and Schonberg also challenge the validity of such arguments on this basis of the lack of empirical studies: See D Fairgrieve, *State Liability In Tort: A Comparative Law Study* (2003) at 130-131; B Markensius, J-P Auby, D Coester-Waltjen and S Deakin, *Tortious Liability Of Statutory Bodies: A Comparative And Economic Analysis Of Five English Cases* (1999) at 81-82; and S Schonberg, *Legitimate Expectations In Administrative Law* (2000), at 19.

Further, the limited (mostly American) empirical studies which have been carried out have produced results which are far from uniform.⁹⁷ In addition to the variability and specific nature of the results of the American studies, it is questionable whether the American experience would readily transfer to Australia or New Zealand.

The most closely relevant study into the issue in the Australasian context is the study by McMillan and Creyke into the effects of adverse judicial review determinations on Australian government bodies.⁹⁸ The findings from that study indicate that in the majority of cases changes in organisational behaviour did result from the adverse judicial determinations. However, aside from a few noted instances, there is no evidence in the study of any predictable or common over-defensiveness or chill factor consequences.⁹⁹ In fact, the study concludes, changes brought about by an adverse judicial review outcome were generally received by affected agencies 'as a valuable and instructive incident.'¹⁰⁰

Empirical evidence aside, academic views on whether and to what extent the issue is a legitimate concern, are many and varied. Some writers have argued that there is no chilling or over-defensiveness phenomenon, based upon the lack of evidence of any such effects when more stringent duties to compensate have been imposed on public bodies in a number of foreign jurisdictions.¹⁰¹ However, qualified support for the view that over-defensiveness is a legitimate concern, particularly

⁹⁷ For example, the American study into the allocational impact of the imposition of liability on highway authorities in the early 1970's by Cordes and Weisbrod did find evidence of the existence of a 'chill factor' phenomenon. See J Cordes and Weisbrod B, 'Government Behaviour In Response To Compensation Requirements' (1979) *Journal of Public Economics* 47. In contrast, a study by O'Leary into the effect of judicial determinations on activities of the United States Environmental Protection Agency was less conclusive. That study found that there were both positive and negative motivational effects on the Agency flowing from a number of significant judicial determinations. See R O'Leary, 'The Impact Of Federal Court Decisions On The Policies And Administration Of The U.S. Environmental Protection Agency' (1989) 41 *Administrative Law Review* 549. There have been a number of additional studies in the United States in which similarly qualified conclusions were reached. These include studies by C Johnson, 'Judicial Decisions And Organisational Changes: Some Theoretical And Empirical Notes On State Court Decisions And State Administrative Agencies' (1979) 14 *Law and Society Review* 27; and B Canon, 'Studying Bureaucratic Implementation Of Judicial Policies In The United States: Conceptual And Methodological Approaches' in M Hertogh and S Halliday (eds) *Judicial Review And Bureaucratic Impact: International And Interdisciplinary Perspectives* (2004). See also C Johnson, 'Judicial Decisions And Organisational Change' (1979) 11 *Administration and Society* 27.

⁹⁸ R Creyke and J McMillan, 'The Operation Of Judicial Review In Australia' in M Hertogh and S Halliday (Eds) *Judicial Review And Bureaucratic Impact – International And Interdisciplinary Perspectives* (2004) at 161.

⁹⁹ Further, at 178, the authors note a particularly pertinent comment from one agency clearly indicating a view that chill factor effects had resulted from an adverse judicial review outcome: 'The court's decision made the department super cautious about adhering to process. They adopted a no risk policy which increased the complexity of the statement of reasons process and made the system more expensive. The expectation of intense scrutiny by the courts meant that "a hell of a lot" more time was spent by the department on the process.'

¹⁰⁰ Ibid at 187. This is the view expressed also by Schonberg, above n 96, and the attitude underpinning judgments such as *Re 56 Denton Road Twickenham, Middlesex* [1953] 1 Ch 51, 58 in which it was observed: 'This judgment can do no harm to the defendants. Let them mark every intimation of a "determination" of theirs as "provisional", "subject to alteration", and "not to be relied on" or words to that effect.'

¹⁰¹ See D Levinson, 'Making Government Pay: Markets, Politic And The Allocation Of Constitutional Costs' (2000) 67 *University of Chicago Law Review* 345 in the context of the United States experience; See also B Markens, *et al*, above n 96, 81-82.

among tort law commentators, is not altogether uncommon.¹⁰² For example, Craig has cautioned against the possibility of a chill factor effect resulting from any change in compensatory remedies available to victims of public authority mistakes.¹⁰³

Most commentators, however, even if broadly supportive of the possibility of some over-deterrent or chill-factor effect, question the concern, albeit on a range of different bases. Levinson, for example, has argued that public authorities respond to political rather than economic ramifications.¹⁰⁴ Others challenge chill factor concerns on the basis that the extent and nature of any motivational impact of a particular judicial determination or legislative imposition of liability will depend upon the nature of the wrong to which that judgment or legislation relates.¹⁰⁵

Given this far from conclusive assessment of the validity of any over-defensiveness concerns, this factor alone would not be sufficient to sustain a stance that the duties of tax commissioners should not be extended to private taxpayers. Consequently, a strong argument can be made that Australian and New Zealand courts considering future private law duty tax claims should resist any submission that judicial determination of any such claim should turn upon these vague and presently largely empirically unsubstantiated 'chill factor' policy concerns.

2. Separation of Powers / Institutional Competence Concerns

Perhaps the most likely public policy explanation for the judicial rejection of the existence of any general private law duties of the Australian and New Zealand Commissioners are implicit judicial concerns that an extension of duties beyond the public sphere would require an intrusion of the judiciary into the legislative sphere and into a consideration of issues which courts and judges are not competent to address. These concerns translate into concerns with offending the separation of powers and/or 'institutional competence' concerns.

Separation of powers concerns reflect a desire to ensure an appropriate separation of powers between the legislature, the executive and the judiciary is maintained and respected.¹⁰⁶ Competency concerns stem from the view that some cases can not be judicially determined because they are cases which courts are 'ill-

¹⁰² The tortious academic literature on this issue is voluminous and varied in its degree of support for this concern as a valid factor for determining exposure to liability of a public authority. See, for example, O Reynolds, "The Discretionary Function Exceptions Of The Federal Torts Claims Act" (1968) 57 *Georgetown Law Journal* 81, 121-123; P Craig and D Fairgrieve, "Barrett, Negligence And Discretionary Powers" [1999] *Public Law* 626, especially at 635; Note, above n 67, 970-971; S Kneebone, *Tort Liability of Public Authorities* (1998), 393; K Stanton *et al*, above n 74, 57; H Woolf, *Protection Of The Public - A New Challenge* (1990), 60; C Peck, "The Federal Tort Claims Act: A Proposed Construction Of The Discretionary Function Exception" (1956) 31 *Washington Law Review* 207, especially at 223; and D Nolan, "Suing The State: Governmental Liability In Comparative Perspective" (2004) 67 *Modern Law Review* 844, 859-860.

¹⁰³ See P Craig, "Compensation In Public Law" (1980) 96 *Law Quarterly Review* 413, 455.

¹⁰⁴ D Levinson, above n 101.

¹⁰⁵ See P Schuck, *Suing Government* (1983).

¹⁰⁶ This concern clearly forms a strong basis for classifying as non-justiciable those matters which are largely political or which involve high level policy decisions. It also encompasses the grounds for rejection of cases involving certain subjects that are considered inherently unsuitable for judicial revisitiation or intrusion such as executive decisions concerning national security. Wilcox J noted in his judgment in *Minister for Arts Heritage and Environment v Peko-Walsend* (1987) 15 FCR 274, 304, that the relevance of a decision to questions of national security would render a matter 'inappropriate' for judicial review.

equipped and ill-suited to assess.’¹⁰⁷ Competency-based justiciability concerns are raised in a range of matters including those which give rise to political issues or bring into question high level policy decisions. They are also raised in those matters which are considered as being unsuited to the adversarial nature of our system of judicial resolution and its rules of evidence and procedure because of their ‘polycentric’ nature.¹⁰⁸

Examples of tax case scenarios in which both separation of powers and institutional competence concerns may be determinative are easy to formulate. For example, it is understandable that Australian and New Zealand judges may well be reluctant to allow a taxpayer to proceed with a damages action against the relevant Commissioner in circumstances that directly or indirectly result in the successful taxpayer paying less tax than would otherwise have been payable on an ordinary reading of the relevant taxation law provisions.

There are two main policy reasons for the tenability of judicial reluctance in these circumstances. First, the rules of evidence which confine the judicial process may make it impossible for a judge to properly assess the competing public policy ramifications of such a result. Second, and perhaps most compelling, such a result could be viewed as an incursion by the judiciary into the domain of the legislature through creation of an exception to an otherwise legislatively sanctioned taxpayer liability. In New Zealand, especially, in light of the obligation of the Commissioner of Inland Revenue to maximise revenue collection contained in section 6A of the *Tax Administration Act 1994*, such concerns could justifiably be afforded some prominence in such a case.

Similarly, any compensation determination which would effectively indicate the substitution of a decision of the Commissioner with the decision of a judge could be viewed as an imposition on the Commissioner of a legal burden which might otherwise operate to restrict or modify the Commissioner’s legislatively sanctioned role. Again, it could be argued that such a determination would pose a judicial challenge to the legislative authority of Parliament. Any successful estoppel claim would be especially open to challenge on this basis.

However, accepted in an unqualified fashion, these concerns can result in the extremely restrictive confinement of tax commissioner duties as evident in the current Australian and New Zealand approaches. Further, there is evidence that zealous or unquestioning pursuit of such concerns may not be sustainable. For example, at a generic level, the judicial importance placed on constitutional separation of powers concerns has been criticised.¹⁰⁹ Commentators such as Davies have discussed at length a number of challenges to the doctrine in the Australian context. For example, Davies observes that the separation of powers doctrine ‘assumes an exaggerated contrast between the accountability of judges and other law-makers. It cannot be

¹⁰⁷ P Craig and D Fairgrieve, above n 102, 632. This argument is sometimes expressed in terms of lack of ‘judicial competency’ or ‘institutional competence.’ For a good discussion of institutional competence concerns see C Finn, “The Justiciability Of Administrative Decisions: A Redundant Concept?” (2002) 30 *Federal Law Review* 239.

¹⁰⁸ Cane has described a polycentric matter as one which requires ‘account to be taken of a large number of interlocking and interacting interests and considerations.’ See P Cane, *An Introduction To Administrative Law* (1986) at 150. American commentator Lon Fuller has vividly described polycentricity by analogy with a spider’s web, noting that: ‘This is a “polycentric situation” because it is “many centred” – each crossing of the strands is a distinct centre for distributing tensions.’ See L Fuller, “The Forms And Limits Of Adjudication” (1978) 92 *Harvard Law Review* 353, 395.

¹⁰⁹ See for example, C Finn, above n 107; and F Wheeler, ‘Judicial Review Of Prerogative Power In Australia; Issues And Prospects’ (1992) 14 *Sydney Law Review* 432.

denied that many features of modern government render the latter less than directly accountable to the electorate.’¹¹⁰

Similar criticisms of the doctrine have also been posed by the UK Law Commission who have noted that ‘constitutional considerations regarding the division of powers between the courts and the executive may be going too far in the direction of stating that the only real control is political and not legal.’¹¹¹ If such views are accurate, then Australian and New Zealand judges should temper their separation of powers concerns in determining future tax cases. This is especially true in Australia, where judges can assess the question of the duties of the Commissioner in a relative legislative vacuum.

The zealous pursuit of competency-based objections to the imposition of private law duties on tax commissioners is similarly questionable. For example, in the tax context, almost any case involving a tax commissioner could at some level be viewed as polycentric. The interests of every taxpayer as a user of tax-funded government services and infrastructure are affected by the challenge to the revenue posed by a significant individual taxpayer compensatory claim. Further, any question involving a publicly funded office such as that held by the Australian or New Zealand Commissioner necessarily raises direct or indirect questions of the allocation of scarce public resources. These questions are inherently political. As one commentator has noted in the administrative law context:

...the potential scope of an exclusion of ‘political’ matters from the purview of the courts is enormous. If all such political ‘hot potatoes’ were to be deemed unsuitable for judicial scrutiny the administrative law casebooks would be slim volumes indeed.¹¹²

3. *Protecting the Revenue – Floodgates/Indeterminacy Concerns*

These concerns revolve around fears that the imposition of private law duties on tax commissioners might lead to an opening of the floodgates to increased litigation, resulting in a large and indeterminate number and quantum of monetary claims. The fear is particularly prominent in claims for pure economic loss as alluded to by Keane J in *Ch’elle*.¹¹³ Again, however, there is doubt whether such concerns can categorically be said to constitute a sustainable basis for the current judicial confinement of the duties of the Australian and New Zealand Commissioners.

Arguably, floodgates and indeterminacy concerns are of potentially greater consequence in the taxation context than in cases involving most other public authorities, because it is recognised that that any challenge to the activities of a revenue authority also indirectly creates vulnerabilities in the funding of the other functions of State and important social initiatives of Government. Accordingly, in the taxation context, judges need to not only consider the ramifications for the revenue

¹¹⁰ See G Davies, “The Judiciary - Maintaining The Balance” in PD Finn (ed), *Essays On Law And Government* (1995) vol 1, 267, 279.

¹¹¹ UK Law Commission, Public Law Team, above n 96, para [2.41].

¹¹² C Finn, above n 107, 249.

¹¹³ The centrality of concerns around indeterminate liability to the restrictive judicial approach in claims for pure economic loss were expressly noted in *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and Assessment Act 1979*, above n 36.

authority of imposing liability on a tax commissioner, but also readily foreseeable flow-on effects to any of a range of other Government activities and initiatives.¹¹⁴

A reduced net 'take' by virtue of increased liability to taxpayers could quite easily be absorbed through reducing the financial resources available to one or more other departments and/or initiatives, rather than being quarantined to the relevant tax authority. Such an impact would not only have unintended financial ramifications, but might distort or dilute any corrective justice intent in any findings of breach of any private law duties by the relevant Commissioner. It may also mean that any positive motivational effects and service delivery improvements from the imposition of private law duties on the relevant Commissioner might be diluted or lost.

While these concerns are potentially valid, judicial support for special protection of the revenue on these grounds is not unanimous. This is evidenced by the comments of Mason CJ in *Commissioner of State Revenue v Royal Insurance Australia Ltd.*¹¹⁵ In that case, His Honour indicated support for the proposition that loss from government error is more fairly borne by the taxpaying public as a whole than by individual victims of error by the revenue authority.¹¹⁶ The comments were made by His Honour in the context of considering the disruption to public finances as a possible defence to a restitutionary claim against the revenue.

Further, while judicial challenges akin to those of Mason CJ to the floodgates argument are rare,¹¹⁷ there is also little empirical evidence to support the existence of any significant floodgates effect from extensions of private law duties of public authorities.¹¹⁸ To the contrary, as noted by the UK Law Commission in the context of extension of civil law monetary liability of public authorities:

It is, however, well-known in the socio-legal literature that decisions to litigate are not just influenced by the absence or presence of a monetary remedy. There may be an increase in litigation even when there has been no change in the liability regime. The relationship between a liability regime and the propensity to litigate is by no means straightforward.¹¹⁹

The UK Law Commission also cite evidence from Germany indicating that despite an extensive State liability regime in that country, and a litigious population, costs associated with negligence claims against the State can be described as 'modest.'¹²⁰

Despite the absence of Australasian empirical studies, it has been noted that often taxpayer desire for an acknowledgement of his or her rights and respectful treatment is a significant driver for seeking redress rather than the sole attraction of monetary compensation flowing from the imposition of private law duties.¹²¹ This fact

¹¹⁴ As Cohen has generally noted: 'The cost may be borne by another department, a bureaucracy independent from the one whose actions are most directly associated with the injury.' D Cohen, 'Suing The State' (1990) 40 *University of Toronto Law Journal* 630, 647.

¹¹⁵ (1994) 182 CLR 51, 68.

¹¹⁶ These observations are discussed in K Mason, 'Money Claims By And Against The State' in PD Finn (ed), *Essays On Law And Government* (1996) vol 2, 104.

¹¹⁷ An English example are the comments of Stuart-Smith LJ in *Capital and Counties plc v Hampshire County Council* [1997] QB 1004, 1043 – 1044.

¹¹⁸ See, for example, the study by Lee into the effect of a number of judicial determinations on local government authorities in the United States, and which found little evidence of increase in the volume of litigation. Y Lee, 'Civil Liability Of State And Local Government: Myth And Reality' (1987) 47 *Public Administration Review* 160.

¹¹⁹ UK Law Commission, Public Law Team, above n 96, at 144.

¹²⁰ Above n 96.

¹²¹ See K Murphy, 'Procedural Justice And Tax Compliance' (2003) 38 *Australian Journal of Social Issues* 379, especially the author's findings reported at 397.

tends to confirm the UK Law Commission proposition that the relationship between litigious activity and increases in public body liability is less than straightforward. However, such evidence falls far short of conclusive, tax-specific Australasian empirical evidence.

Accordingly, the existence and/or extent of any likely floodgates phenomenon which might result from the extension of private law duties to the Australian or New Zealand Commissioners is presently impossible to reliably predict. In these circumstances, floodgates/indeterminacy concerns cannot presently be considered a completely sustainable foundation for the continued judicial rejection of any private law duties of the Australian and New Zealand Commissioners.

IV CONCLUSIONS

This article has confirmed that there is a clear judicial reluctance to hold the Commissioner of Taxation and Commissioner of Inland Revenue respectively to any duties beyond their statutory duties to the Crown in both Australia and New Zealand. It is equally evident, however, that the sustainability of this general judicial rejection of any private law duties to taxpayers in both jurisdictions is questionable on either legal robustness grounds and / or insofar as that rejection stems from one or more of the most frequently raised public policy grounds.

Specifically, insofar as legal robustness is concerned, the approach taken in the Australian tax cases is particularly lacking in any express and direct reference to unambiguous supporting legislative or common law authority or application of well-established legal principles. This deviation from the typical approach to determining the scope of private law duties of public bodies in the Australian tax context is difficult to objectively justify. It is simply not sustainable in the face of challenge on grounds of legal robustness.

In contrast, the New Zealand judicial reasoning is sustainable on these grounds, demonstrating much of the legal rigour and detail lacking in Australia, albeit aided by a much clearer legislative framework. This is not to say that the New Zealand judicial approach is completely immune from criticism. As noted in Part II, there appears to be lacking an approach to interpretation of legislative provisions such as sections 6 and 6A of the *Taxation Administration Act 1994* (NZ) which takes into account the possibility that the wording of those sections is broad enough to allow for consideration of taxpayer private rights in the fulfilment by the Commissioner of his primary duties to the Crown. Nevertheless, the concern here is with robustness and sustainability rather than incontestable correctness. Accordingly notwithstanding the possibility of some challenge on these grounds, on this score, the New Zealand approach stands up to scrutiny as relatively more robust than the Australian approach.

Turning to the public policy concerns which underlie both the Australian and New Zealand approaches, the discussion in Part III has demonstrated that none of these concerns have been singularly empirically incontrovertibly tested (either in the tax context or more generally). Nor are any of these concerns uniformly accepted by learned commentators as valid considerations. Accordingly, to the extent that the judicial reasoning in both jurisdictions either expressly or implicitly rests on the unquestioned validity of these concerns, the sustainability of that judicial reasoning is also open to question.

The overall picture that emerges is of a judicial approach in both countries which may ultimately prove unsustainable in the face of well-reasoned challenge. Australian taxpayers are particularly disadvantaged, however, by the lack of clear

guidance as to the justifications for the current judicial stance on the issue of the Australian Commissioner's duties. This disadvantage may be ameliorated through a well-considered and detailed judicial statement on the issue similar to the guidance New Zealand judges have provided in determining the New Zealand cases. Ideally, however, Australian legislators will see fit to clarify the extent to which, and circumstances in which, private law duties are intended to be imposed on the Commissioner of Taxation in carrying out his tax administration function. The New Zealand legislature has at least gone some way down this path with enactment of the 'care and management' provisions of the *Tax Administration Act 1994*.

Notwithstanding, the analysis of the sustainability of the approach to the duties of the Commissioner in Australia and New Zealand in this article demonstrates the continuing need in both countries for a comprehensive weighing up of the competing public and private interests which arise in any case in which tortious or equitable wrongdoing is alleged by a taxpayer against a tax authority. In this way, public policy concerns can be tested and balanced against competing taxpayer rights concerns. This balancing exercise is important as Australian judge, Hill J, has extra judicially cautioned:

The Income Tax legislation may impose trust in the Commissioner to perform his tasks properly and impartially as he generally does, but his actions must not be immune from review. The inescapable fact that taxation is the cornerstone of society must not be allowed to stand as a justification for arbitrary acts, bullying or the erosion of civil rights in the name of exaction of taxes.¹²²

¹²² D G Hill, 'What Do We Expect From Judges In Tax Cases?' (1995) 69 *Australian Law Journal* 992, 1005.

THE FINANCING EFFECT: WILL A TAX TRANSPARENT FORM FOR CLOSELY HELD BUSINESSES IN AUSTRALIA ASSIST WITH FINANCING?

BRETT FREUDENBERG*

One of the potential reforms to be considered by the Henry Review¹ is a proposal by the Institute of Chartered Accountants Australia and Deloitte for the introduction of a tax transparent company (the ICAA proposal).² The central proposition of the ICAA proposal is that the introduction of a tax transparent company will be beneficial to closely held businesses in Australia. An issue facing closely held businesses can be in terms of financing, and this article will consider whether the introduction of a tax transparent company is likely to assist closely held businesses with this. This analysis will consider the model outlined in the ICAA proposal, as well as a number of foreign transparent company forms, particularly: United States' S Corporations and limited liability companies (LLC), the United Kingdom's limited liability partnership (LLP) and New Zealand's Loss Attribution Qualifying Company (LAQC). Through this analysis, a number of areas of concern will be raised about the interaction of a tax transparent company with financing, particularly in terms of eligibility requirements, assessment for unpaid allocations, comparison to corporate tax treatment and active members. It will be argued that as currently structured the ICAA proposal is unlikely to substantially assist closely held businesses address their financing problems and that a partial loss transparent company would be preferable model in this regard.

I INTRODUCTION

Recently the Australian government announced that the proposal for a tax transparent company by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) will be considered in a Tax Review to be chaired by Ken Henry (the Henry Review).³ The contention of the ICAA proposal is that a tax transparent company will assist closely held businesses.⁴ While there have been some criticisms of the claims of decreased compliance cost in the ICAA proposal⁵ it is argued that another area of concern for this sector is financing.

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¹ Australia, *Australia's Future Tax System – Consultation Paper*, (Henry, K Chairman), (2008).

² Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission*, (2008).

³ Australia, *Australia's Future Tax System – Consultation Paper*, (Henry, K Chairman), (2008).

⁴ Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission*, (2008), 9 and 12.

⁵ Brett Freudenberg, 'Fact or fiction? A sustainable tax transparent form for closely held businesses in Australia' (2009) 24(3) *Australian Tax Forum* 375.

The raising of finance (in terms of equity and debt) can be a challenge for closely held businesses, which can be attributable to both internal and external factors.⁶ In what respect does tax transparency — that is, disregarding the legal form and allocating income and/or losses directly to members — assist or hinder closely held businesses in meeting their financing requirements. It is argued that it is important for the issue to be considered in the Australian context, as some transparent companies have been attributed to tax arbitrages unique to their jurisdictions.

This article will consider how transparent companies potentially affect closely held businesses' financing, by considering not only the ICAA proposal, but also a number of foreign tax transparent companies, being: United States' S Corporations and limited liability companies (LLC), the United Kingdom's limited liability partnership (LLP) and New Zealand's Loss Attribution Qualifying Company (LAQC). The consideration of foreign jurisdictions may highlight beneficial and adverse effects of tax transparency which at first consideration may not be obvious. Such an analysis will demonstrate that in the jurisdictions studied, compared to an entity or integrated system, consistent advantages of tax transparency are the treatment of tax preferences, losses and the imposition of a single layer of tax on capital gains. These tax advantages could assist closely held businesses in addressing their financing issues. However, it will be argued that tax transparency does not necessarily result in an overall lower tax burden. This depends upon several factors including the relationship between the tax rates applying to corporations, capital gains and individuals. Also eligibility requirements and the assessment of unpaid allocations can be adverse. Another issue implicated in this analysis, is the appropriate tax status of transparent company members as either 'employees' or as 'self-employed'.

Through this analysis it will be argued that it is questionable what benefits in terms of financing will accrue to closely held businesses through the ICAA proposal. Instead it will be argued that a preferable approach to assist Australian closely held businesses in terms of financing is for the introduction of a partial loss transparent company.

The next section of this article will outline the definition of tax transparent companies and how they may be classified. Then the ICAA proposal will be outlined, as well as the issues closely held businesses in Australia can face in terms of financing. The article will then consider the overseas experience as well as reflecting upon the ICAA proposal in terms of financing. The potential reasons why transparency may aid or hinder financing will be considered. The final section of the article will outline the conclusions as to whether the ICAA proposal will assist closely held businesses in terms of financing.

II WHAT IS A TAX TRANSPARENT COMPANY?

The combined attributes present in the tax transparent company considered are a corporation's separate legal entity status⁷ and limited liability, with a general

⁶ For example an internal characteristic of closely held businesses obtaining finance is that members may want to retain 'control'. An external factor could be that banks are hesitant to lend to a business without an established track record.

⁷ Or legal personality.

partnership's flow-through taxation treatment.⁸ It is these three core characteristics that define the nature of a tax transparent company (or transparent company).⁹

Utilising these attributes, a 'fully transparent company' allows for all income and losses of the transparent company to flow-through directly to its members.¹⁰ In other words, all of the transparent company's income (whether distributed to members or retained) is allocated and assessed for tax purposes to members. The transparent company's losses, when deductions exceed assessable income, are similarly directly allocated to members. Normally, in this respect, a conduit principle applies to these allocations, so that receipts and expenditure items of the business form retain their identity for members.¹¹ Note even though transparency applies, at times there can be recognition of the business form for tax purposes (referred to as entity acknowledgement), such as the lodgement of information tax returns by the business form or the selection of depreciation methods.

In relation to the continuum conceptualised in Figure 1 pertaining to the taxing of business forms, a fully transparent company represents the aggregate approach. However, the fully transparent company, unlike a general partnership, also provides for limited liability¹² and is a separate legal entity from its constituent members.

⁸ Tax transparent treatment is argued to be an attribute of general partnerships, particularly in the Australian context.

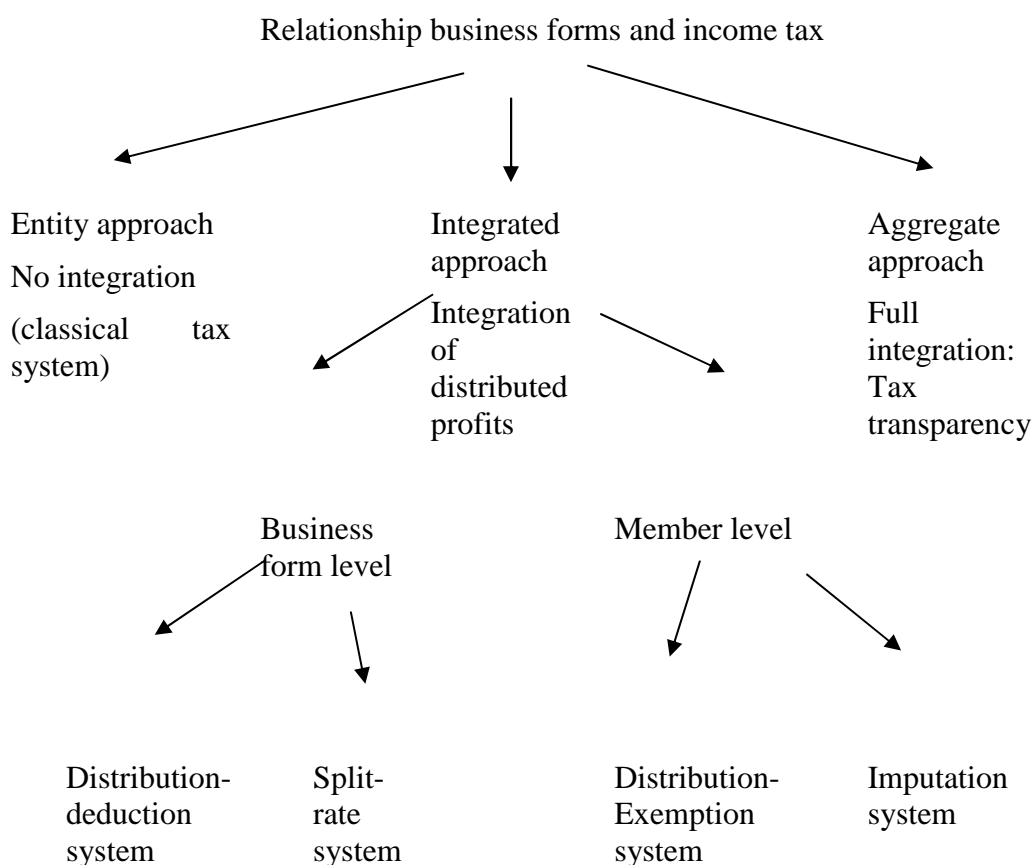
⁹ Important terms associated with tax transparency are 'allocations' and 'distributions'. 'Allocations' refer to the allocating of income or losses for tax purposes directly to members even though, legally, the income and/or loss may have been earned or been incurred by the business form. 'Distributions' refers to the payment or the transfer of assets (including money) to members of the transparent company.

¹⁰ Referred to as aggregate approach, transparency or flow-through taxation.

¹¹ For example if the transparent company sold a capital asset, the proceeds of that sale would be regarded as capital in nature in the hands of the member(s). This would mean that the member(s) might be able to access any capital gain concession, such as the 50 percent discount: *Income Tax Assessment Act 1997 (Cth) (ITAA 1997)*, Div 115.

¹² The extent of limited liability protection does vary amongst transparent companies.

Figure 1: The continuum of the taxation of business forms¹³



Consideration of transparent companies is not new, and reference to them can be found internationally in the various jurisdictions. For example: Canada: Carter Commission in 1966;¹⁴ and the United States: Blueprints for Basic Tax Reform in 1977, and in 1992¹⁵ and the American Law Institute Federal Income Tax Project – Taxation of Private Business Enterprises in 1999.¹⁶ In Australia, reference to tax transparent companies has been quite pervasive: in the 1975 Asprey Report,¹⁷ the 1981 Campbell Committee’s¹⁸ enquiry into the Australian

¹³ Figure modified from Sijbren Cnossen, ‘Alternative Forms of Corporation Tax’ (1984) 1 *Australian Tax Forum* 253, 255.

¹⁴ Canada, *Carter Commission, Royal Commission on Taxation*, (1966).

¹⁵ US Department of Treasury, *Blueprints for Basic Tax Reform* (Treasury 1) (1977); US Treasury Department. Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992).

¹⁶ George Yin and David Shakow, “Taxation of Private Business Enterprises”, In *Federal Income Tax Project* (1999). Under the proposal, a simplified conduit system, which resembles a liberalized version of Subchapter S, would be available to certain private firms.

¹⁷ Australia, *Asprey Report, Taxation Review Committee Full Report*, (1975), [16.79 to 16.96]. The Asprey Committee did not regard the scheme as being primarily directed to assisting small companies [16.85] or available to the subsidiaries of large or foreign companies [6.89].

¹⁸ Australia, *Campbell Report, Committee of Inquiry into the Australian Financial System — Final Report*, (1981), 223. The Campbell Inquiry recommended full integration in the interests of equity and neutrality, stating that the fact that companies and their shareholders were separate did not

financial system, and the Government's 1985 Draft White Paper.¹⁹ It should also be noted that in 1998 the Ralph Committee referred to the tax transparent treatment of corporations.²⁰ More recently the Australian government announced that the ICAA proposal for a tax transparent company will be considered in the Henry Review.²¹

The ICAA proposal advocates for the introduction of tax transparent company, particularly for micro enterprises.²² The proposal, if implemented, would see transparency through application of the general partnership tax provisions to corporations and unit trust which elect to be part of the regime.²³

A reason underlying the ICAA proposal is that tax transparency could remove the need for the application of complex tax integrity measures imposed to address the disguised distribution of profits from private corporations, and thereby reduce compliance costs.²⁴ Whether the ICAA proposal would reduce compliance costs is questionable, as evidence from foreign jurisdictions would tend to indicate that tax transparent companies increase compliance costs.²⁵ Part of potential complexity is the compliance with integrity measures, such as loss restriction rules, to ensure that a transparent regime is not abused.²⁶ Nevertheless, the ICAA proposal contends that a tax transparent company would be a preferable mechanism to tax closely held businesses in Australia.

A reason underlying such a proposal is that economists have advocated for tax transparency (an aggregate approach) as an ideal model,²⁷ as it can improve tax neutrality, reducing the impact of tax on consumption choices.²⁸ In

justify their separate tax treatment. It was not convinced that operation of an enterprise under limited liability should result in an additional tax burden.

¹⁹ Australian Treasury, *Draft White Paper on the Reform of the Australian Tax System*, (1985).

²⁰ Australia, *Ralph Report No 1, A strong foundation*, (1998), [277] of Overview.

²¹ Australia, above n 1, 155. Chris Emerson (Innovation, Industry, Science and Research Minister), *Media Release: Simplifying Small Business Taxation Under Consideration by Rudd Government* (2008).

²² Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].

²³ The ICAA proposal applies to unit trusts as well as corporations. Institute of Chartered Accountants in Australia and Deloitte, above n 2, 6.

²⁴ The ICAA proposal argues that Division 7A would not need to apply nor fringe benefits tax for benefits to employee-members: Institute of Chartered Accountants in Australia and Deloitte, above n 2, 9 and 12. Other complex provision that need not necessarily apply to a transparent company could include share value shifting (*ITAA 1997* (Cth), Div 723 to 727), tracing capital gain discounts (*ITAA 1997* (Cth), s 115-40), and tracing rules for capital assets acquired prior to 20 September 1985 (*ITAA 1997* (Cth), CGT event K6). Furthermore, a tax transparent company could provide an alternative form of tax consolidations which can be problematic for small businesses.

²⁵ Freudenberg, above n 3.

²⁶ For a discussion about the integrity measures that can apply to tax transparent companies see: Brett Freudenberg, 'Losing My Losses: Are the Loss Restriction Rules Applying to Australia's Tax Transparent Companies Adequate?' (2008) 23(2) *Australian Tax Forum* 125.

²⁷ Another term that can be used to describe an aggregate approach is 'fiscally transparent'. Jeffrey Kwall, *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners* (3rd ed 2005), 10. John Head, *Company Tax Systems: From Theory to Practice*. In *Company Tax Systems*, edited by J Head and R Krever (1997), 22: "In the traditional public finance literature, full integration of the corporate income tax with the personal income tax has long been viewed as the relevant 'blueprint' or ideal". Cnossen, above n 11, 262: "For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labour income, such as wages and salaries that is solely subject to the individual income tax".

²⁸ Australia, above n 15, 16.

comparison, the 'entity' approach can cause a number of distortions, including the favouring of the retention of profits. This is because the distribution of profits to members results in additional tax being assessed to the member, and therefore it can be perceived as preferable to shelter income in the business form. Such retention of profits within the business form may have several adverse consequences.²⁹ Another potential distortion of an entity approach is that it can discriminate against equity funding compared to debt because interest on debt for the business form is tax deductible compared to profit distributions to members.³⁰ In comparison, tax transparency is stated to improve or enhance the tax neutrality and equity of a tax system, compared to an entity approach.³¹ The Organisation for Economic Co-operation and Development (OECD) in its 1991 report espoused a preference for transparency:

Equity and neutrality would best be achieved under a tax system in which there were no taxes on organizations as such, and all individuals and families holding interests in organizations were taxed on the accrued net gains from such interests on the same basis as all other net gains.³²

The adoption of tax transparent treatment can achieve greater horizontal and vertical equity and this is because there is an alignment in the taxation of business profits with the notion of the capacity to pay tax.³³ Furthermore, tax transparency can achieve greater equivalent tax treatment on debt and equity.³⁴ Also it has been argued that, in addition to their economic benefits, tax transparent companies are advantageous for closely held businesses.³⁵

Historically, however, it has been argued the implementation of such an economic ideal is problematic for business forms with limited liability and separate legal entity status.³⁶ The asserted difficulties relate to the potential of risk to revenue, allocation and administrative issues, complexity and the pressure to distribute money. A consequence of this has been that jurisdictions provide for either an entity approach or a form of integration, rather than full transparency to such business forms.

²⁹ Note in Australia this potential distortion when an entity tax system applied was addressed by applying an 'undistributed profits tax' on private corporations if they failed to distribute at least a prescribed amount of their after-tax income.

³⁰ Richard M Bird, Corporate-personal tax integration. In *Tax Coordination in the European Community*. (1987), 243. Lynne M Oats, *The Evolution of Federal Company and Shareholder Taxation in Australia: 1915 – 1995*, (2000), 39.

³¹ Paul Bevin, *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform*, (1985), 96. Peter Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (1996), 107. George Yin, 'Corporate Ideal' (1992) 47 *Tax Law Review* 431, 433.

³² OECD, *Taxing Profits in a Global Economy: Domestic and International Issues*, (1991), 23.

³³ Yin and Shakow, above n 14, 70. Oats, above n 28, 39: "This presupposes profitability as an acceptable measure of ability to pay tax".

³⁴ Bevin, above n 29, 96, and Bird, above n 28, 235.

³⁵ Andrew Hicks, Robert Drury and Jeff Smallcombe, "Alternative Company Structures for the Small Business", In *ACCA Research Report No 42* (1995), 53. House of Commons – Select Committee, *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill* (1999), [65]; and Ken Holmes, 'The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand' (1992) 9 *Australian Tax Forum* 321.

³⁶ There has been a greater willingness for jurisdictions, including Australia, to have tax transparency for business forms which do not provide a separate legal entity and liability protection. For example, transparency generally applies to sole proprietors and general partnerships.

However, there are several examples of foreign jurisdictions embracing a fully tax transparent approach for business forms with separate legal status and liability protection for members. Examples of these tax transparent companies include the United States' S Corporations and LLCs, the United Kingdom's LLPs and New Zealand's LAQCs and its new limited partnership regime.³⁷

It is argued, in this respect, that the United States' S Corporation and LLC, as well as the United Kingdom's LLP, are fully tax transparent companies.³⁸ However, the LAQC is not a fully transparent company, but instead is a 'partial loss transparent company', with only the losses are automatically allocated to members, with income initially taxed to the business form.³⁹ It is these foreign transparent companies that will be studied to evaluate the claims within the ICAA proposal of a tax transparent company being a benefit for Australian closely held businesses in terms of financing.

III FINANCING AND CLOSELY HELD BUSINESSES

One of the problems confronting closely held businesses can be in terms of financing, whether this be from internal or external sources. To an extent the financing problem can be self-inflicted. While the problems discussed could have equal application to widely held business, it is argued that inherently they can be more evident for closely held businesses, particularly with small operations. Research demonstrates that very few small corporations attract any equity other than from active members.⁴⁰ Consequently, equity finance from active members can be an essential source of financing, especially in the early years of operation.⁴¹ Some research has indicated that equity (including retained profits) is a less important source of finance for small businesses when compared to that of widely held corporations.⁴² However, this research must be qualified, as much of the long-term debt for closely held business is in the form of member loans,⁴³ with member guarantees and personal assets used as security not being recorded on the balance sheet.

An inhibitor to attracting additional equity investment is that existing members may want to retain control and can resist attracting additional members

³⁷ Other tax transparent companies introduced around the world include Singapore's LLP, Northern Ireland's LLP and Japan's LLP and LLC. Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack the separate legal entity status. For example: (a) Germany the GmbH&Co.KG which uses a corporation (known as a GmbH) as the general member of a limited partnership (known as a KG); and (b) France the SAS.

³⁸ Brett Freudenberg, 'Are transparent companies the way of the future for Australia?' (2006) 35(3) *Australian Tax Review* 200.

³⁹ Similar to the fully transparent company, the partial loss transparent company also provides for limited liability and the notion of a separate legal entity.

⁴⁰ Andrew Hicks, "Legislating for the Needs of the Small Business", In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas (1997), 58.

⁴¹ In the years of operation the business may not have the 'track record' to satisfy creditors, nor have tangible assets which can stand as security for the loans.

⁴² Brian Johns, Winston Dunlop and WJ. Sheehan, *Small Business in Australia: Problems and Prospects* (1983), 110: referring to Table 7.1.

⁴³ Johns et al., n 42, 110: Note the study refers to 'director loans' however this appears to be a mistake in the correct nature of the loans given the prior discussion in the document.

because of concerns with the dilution of control.⁴⁴ This can apply when operations are small or large, as there can be a ‘high value’ placed on freedom and the opportunity to control.⁴⁵ For some closely held businesses there may be little desire for business growth.⁴⁶ In Australia, it is estimated that 70 percent of small and medium enterprises are ‘traditional’, following a low growth path, with few if any growth aspirations, and exist principally to provide their members with a source of employment.⁴⁷ However, for those businesses wanting to expand, this financing problem means that they may not possess sufficient capital or retained earnings to carry their development opportunities to fruition.⁴⁸

In respect of sourcing outside loans there can be a number of intrinsic problems.⁴⁹ Regardless of size, external financiers may be reluctant to finance closely held businesses, particularly if there is no tangible property to secure the finance and/or a viable business track record.⁵⁰ Another factor is that such outside loans are often regarded as risky, so financial institutions may charge a ‘funding premium’ (often in the form of higher interest rates), particularly if operations are small. This means closely held businesses can face higher borrowing costs than larger businesses. Also, this can mean that such businesses do not qualify for normal business loans.⁵¹ Additionally, outside loans will generally require interest to be paid regularly, whereas a business that raises capital through equity will not be required to make regular distributions, except in unusual circumstances. Regular payments to an external financier require a matching of cash flows to obligations and this can present difficulties for closely held businesses which may have lumpy cash flows or may be unsophisticated in carrying out the precise provisioning required. This can lead to defaults on outside loans, even though the business is expanding.

These circumstances can lead to small closely held business relying more heavily on overdraft facilities, which may result in a higher level of cost due to

⁴⁴ Johns et al., n 42, 29. Judith Freedman, ‘Small Business and the Corporate Form: Burden or Privilege’ (1994) 57 *The Modern Law Review* 555, 581: “Small business research has shown clearly that one of the major barriers to growth of small firms is the desire for independence and the unwillingness to part with control, particularly by the alienation of equity in a company”.

⁴⁵ SJ Naude, ‘The need for a new legal form for small business’ (1982) 4 *Modern Business Law* 5, 5. Johns et al., n 42, 29.

⁴⁶ Johns et al., n 42, 29.

⁴⁷ Australian Chamber of Commerce and Industry, Evaluation of Small Business Assistance Programs: ACCI Submissions to the Office of Small Business (2003), 6: Senate Report on Small Business Employment [Employment, Workplace Relations and Education References Committee, Small Business Employment, February 2003].

⁴⁸ Stephen Barkoczy and Daniel Sandler, *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46 (2007), 20. John Howard (Prime Minister), More Time for Business: 24 March 1997: “Many small businesses are constrained in their development and growth by a lack of access to appropriate sources of finance. If small businesses are to innovate, take up new technology and export, they need an accessible financial market that offers a wide range of financial products”.

⁴⁹ Barkoczy and Sandler, above n 48, 20.

⁵⁰ It has been said that the finance gap is for ‘new and start-up’ businesses rather than small businesses: Teresa Graham, *Graham Review of the Small Firms Loan Guarantee: Recommendations* (2004).

⁵¹ Neil Mann, “The Tax Office and the Challenges for Small to Medium Enterprises”, In *Taxing Small Business: Developing Good Tax Policies* (2003) 183, 127: “Banks in lending to SMEs often incorporate a substantial risk margin. This can increase SME variable rates by up to 5 percentage-lending points”.

charges.⁵² Furthermore, to support outside loans, members may be required to give personal guarantees for such debt, or to offer personal assets as security.⁵³ Such personal guarantees would prejudice on the limited liability protection that may be provided by the business form, as the guarantee makes the member liable for principal and interest payments on default.

In Australia it appears that taxes also hinder financing, as taxes are identified as the primary constraint on investment for small and medium enterprises.⁵⁴ This is reinforced by the fact that small businesses account for two-third of unpaid taxes to the Australian Tax Office.⁵⁵

The relationship with financing and closely held businesses⁵⁶ is important because, if it is accepted that most small and medium enterprises are closely held, then when aggregated they can account for a large percentage of a country's economic activity. For example, it was estimated that in Australia there were 1,233,200 private sector small businesses⁵⁷ during 2000–2001, representing 97 percent of all private sector businesses and employing almost 3.6 million people (49 percent of all private sector employment).⁵⁸ Small businesses account for around 30 percent of Australia's gross domestic product.⁵⁹ For this reason, this sector has been described as 'the engine room of the Australian economy'.⁶⁰

⁵² J Bisacre, "A European Perspective on Small Business and the Law", In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas (1997), 89.

⁵³ Johns et al., n 42, 113. Which, given that they are not recorded in the balance sheet can sometimes give the misleading impression that the bank is providing more funds to start the business than the member.

⁵⁴ Australian Chamber of Commerce and Industry, *Survey of Small Business: Identifying Trends and Conditions within the Small Business Sector* (2003), 7: "Top five constraints on investment: Small Business: Business Taxes and charges; Availability of suitably qualified employees; wage costs; state government regulations; non-wage labour costs. Medium Business: business taxes and government charges; availability of suitably qualified employees; local competition; non-wage labour costs; state government regulation. Large business: federal government regulations; availability of suitably qualified employees; state government regulations; wage costs; business taxes and government regulations".

⁵⁵ Colin Brinsden, *Small business account for two-thirds of unpaid taxes* (13 June 2007).

⁵⁶ For the purposes of this article, the qualitative characteristics inherent for a 'closely held business' is that membership interest is not widely dispersed, and that it is not publicly traded: Scott Holmes and Brian Gibson, *Definition of Small Business* (2001), 8; Cynthia Coleman and Chris Evans, *Tax Compliance Issues for Small Business in Australia. Taxing Small Business: Developing Good Tax Policies* (2003) 147, 149; Small Business Deregulation Task Force, *Time for Business* (1996), 13. Normally, a closely held business is one that is independently owned and operated, with most, if not all, capital contributed by members and managers. Furthermore, members are likely to participate in the management of the business (member-management). Due to these characteristics it has been stated that 'it is difficult to view closely held' businesses regardless of the structure used as 'economic entities independent of their owners': Harris, above n 29, 47. While it is acknowledged that 'closely held' and 'small business' are not *per se* interchangeable, the vast majority of closely held businesses will nonetheless be small to medium enterprises. However, there can be a number of closely held businesses that are large. Judith Freedman and J Ward, 'Taxation of Small and Medium-Sized Enterprises' (2000) *May European Taxation*: 158, 159.

⁵⁷ Defined to be businesses that employ less than 20 people.

⁵⁸ Australian Bureau of Statistics, *Small Business in Australia 2001*. (2002).

⁵⁹ Australian Bureau of Statistics, above n 58. Neil Warren (ed), *Foreword. Taxing Small Business: Developing Good Tax Policies* (2003) 11–12, 11; and Coleman and Evans, above n 56, 147.

⁶⁰ John Howard (Prime Minister), *More Time for Business*: 24 March 1997.

Accordingly, whether a tax transparent company might assist closely held businesses with their financing needs to be carefully analysed. Within this article financing will be considered by analysing the eligibility for transparency and the overall tax burden, in terms of unpaid allocations, losses and tax preferences, capital gains, corporate tax treatment, active members and debt versus equity funding.

IV ELIGIBILITY FOR TRANSPARENCY

For a jurisdiction to allow for a tax transparent company there can be eligibility requirements. The ICAA proposal suggests that its flow-through regime be restricted to corporations and unit trusts that are private⁶¹ with five or fewer members.⁶² However, this low quantum of members is based on the proposal only extending to 'micro-SME groups',⁶³ to reduce the potential impact on tax revenue. Indeed, do eligibility requirements have to be so restrictive? For the foreign transparent companies studied, LLCs and LLPs have minimal eligibility requirements for transparency, whereas for S Corporations and LAQCs have strict requirements. This facet is of major importance because eligibility requirements can restrain the ability to raise equity due to, for example, requirements concerning classes of membership interest; membership numbers; members' status; and business activities.⁶⁴

The requirement for a transparent company to have only one class of membership interest can restrict the ability to raise equity.⁶⁵ This is because new equity members may require preferred membership interests or, alternatively, interests with specific rights attached to them to invest equity so as to expand operations.

Another way the ability to raise equity finance can be constrained is via restrictions on the quantum of members allowed. As an illustration of this point, an S Corporation is now restricted to comprising 100 members. While this is a substantial increase from the original ten allowed,⁶⁶ it does nevertheless place an arbitrary cap on the number of members.⁶⁷ Similar to the ICAA proposal, for LAQCs the raising of equity is restricted to five members, although this can be

⁶¹ A 'private' entity based on a definition similar to that found in *ITAA 1936* (Cth), s 103A.

⁶² Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].

⁶³ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].

⁶⁴ Furthermore eligibility requirements could have a relationship with regulatory complexity. See: Freudenberg, above n 3.

⁶⁵ The requirement for one class of membership interest applies to S Corporations and LAQCs. *IRC 1986* (US), s 1361(b)(1)(D). *ITA 2007* (NZ), ss HA 1 to HA 10.

⁶⁶ Originally, back in 1958, only ten members were allowed; subsequent amendments raised the number to 15 (1976), then 25 (1981), then one year later to 35 (1982), then 75 (1997) and finally 100 (2005). Amended by section 232 of *American Jobs Creation Act 2004* (US), amending *IRC 1986* (US), s 1361(b)(1)(A)). This limitation applies to the number of members at any one time during the taxable year.

⁶⁷ However, the potential membership of an S Corporation may exceed 100, due to the treatment of family members within six generations as one member: *IRC 1986* (US), s 1361(c)(1)(B) [applying from 1 January 2005]. A family is defined to include members with a common ancestor, lineal descendants and spouse (including former spouse) at the time of the election six or less generations from the youngest generation of members part of the family, part from the operation of the section. Prior to 1 January 2005, most joint owners were counted separately: Treasury Regulation, s 1.1371-1(d)(1), although a husband and wife [and their estates] could be treated as one member: *IRC 1986* (US), s 1361(c)(1).

circumvented by investors forming a general partnership of a number of LAQCs,⁶⁸ and treating blood relatives as ‘one’ member.⁶⁹ However, the concurrent use of business forms and the treatment of family members, inevitably increases complexity and calls into question the need for a cap in the first place.

An additional restriction on the raising of equity is that only certain types of entities can be members and this thereby inevitably excludes certain persons or entities. For example, an S Corporation may raise equity from resident individuals⁷⁰ – except in restricted circumstances.⁷¹ Theoretically, this restriction means, in effect, that a C Corporation could not become a member of an S Corporation. In contrast to S Corporations, New Zealand’s LAQC may have non-resident members, although adverse tax implications may effectively deter this.⁷² For S Corporations it is understood that non-residents were excluded due to the potential risk to revenue as allocated income to a non-resident member may have escaped taxation in the United States. This is because if a non-resident S Corporation member was not actively involved in the business, then as a non-resident only fixed income (interest and dividends) sourced in the United States would be taxed - with other income not subject to tax.⁷³ It was for similar concerns that the residency requirement for LAQCs (compared to members) in New Zealand was one of the eligibility requirements.⁷⁴ However, others have

⁶⁸ Committee of Experts on Tax Compliance, *Tax Compliance: Report to the Treasurer and the Minister of Revenue*: Chapter 6 – Tax Mitigation, Avoidance and Evasion . (1998), [6.107]. The structure of a general partnership of LAQCs has been widely used in the forestry industry since shortly after enactment of the LAQC regime. In the United States the use of general partnerships in this fashion to increase membership of S Corporations was originally ruled against: Revenue Ruling 77-220, 1977-1 C.B. 263.

⁶⁹ There are a number of special rules that allow more than five members, including the treatment of blood relations, nominees, corporate members and trustee members. Inland Revenue (NZ), *Qualifying Companies: A guide to qualifying corporation tax law*, (March 2001), 13 [cited 6 January 2008]. Available from <http://www.ird.govt.nz/forms-guides/keyword/businessincometax/companies/ir435-guide-qualifying-companies.html>.

⁷⁰ *IRC 1986* (US), s 1361 (b)(1)(C).

⁷¹ Only in restricted circumstances can a member be a corporation, or general partnership or trust. For example an S Corporation could not be a member of an affiliated group as defined in *IRC 1986* (US), s 1361(b)(2)(A). S corporations can now hold 100 percent of membership interest in a subsidiary, and can elect to treat the subsidiary as a Qualified Subchapter S Corporation (QSSS): *IRC 1986* (US), s 1361(b)(3)(B).

⁷² The benefit for a non-resident member investing into an LAQC may be limited; since the effective tax rate applying to distributions to them could be higher compared to if their investment was structured through a different business form. For members of an LAQC, who are New Zealand non-residents, imputation credits must still be attached to dividends paid to non-resident members, and are therefore wasted because non-resident members cannot normally claim a credit for them against their New Zealand tax liability, or for most members’ jurisdictions, against their home country tax liability. See: Brett Freudenberg, ‘Is the New Zealand Qualifying Company regime achieving its original objectives?’ (2005) 11(2) *NZJTL* 185, 207. While not restricting equity investment, the restriction on an LAQC not having greater than \$10,000 non-dividend income source from outside New Zealand could limit the LAQC’s operations and limiting the ability to attract equity investors.

⁷³ A foreign member is allowed a credit for the tax withheld. If the income is not connected with trade in the United States then the withholding tax rate is generally 30 percent unless a Double Tax Agreement applies a lower rate: *IRC 1986* (US), s 1146(a). George Mundstock, *A Unified Approach to Subchapter K & S*, (2006), 229.

⁷⁴ In the New Zealand circumstances the residency requirement was to ensure that the foreign dividend withholding payment regime was not deliberated: Freudenberg, above n 72, 195.

pointed out that rather than excluding non-resident members, this could be addressed by applying withholding tax rules.⁷⁵

For example, because the taxation of the United States' LLC and its members occurs pursuant to a different sub-chapter, this means that LLC members are regarded as engaged in the business activity conducted by the LLC, and accordingly they are automatically subject to withholding tax on allocations to them.⁷⁶ Others have argued that non-residents should also be excluded due to the potential complexity involved, including calculating the appropriate level of tax due to ascertaining world-wide income and administrative problems in applying a withholding tax.⁷⁷

Nevertheless, it is argued while allowing non-resident members does potentially impose a risk to revenue, provided there are adequate withholding measures for allocations to them, they should not be excluded. Indeed, by excluding non-residents from being eligible members, there is the potential to breach the non-discrimination article in Double Tax Agreements that Australia has entered into with other countries.⁷⁸ Another concern with non-resident members is that there may be an erosion of the tax revenue due to lower rates of withholding tax applying to their allocations pursuant to Double Tax Agreements.⁷⁹ However, determination of this depends upon how the allocation to members are characterised. If allocations are treated as 'dividend' payments, then lower withholding tax rates can apply.⁸⁰ However, if instead members are treated as carrying on the underlying business of the transparent company, then the appropriate article would be the 'business profits' which does not generally benefit from the lower withholding tax rates.⁸¹

The raising of equity is a highly significant issue and the capacity of a business form to facilitate it has been identified as an important feature. It is understood the formation of capital is one of the reasons behind the popularity of LLCs.⁸² The 'formation of capital' was one of the original reasons behind the introduction of the corporation one hundred and fifty years ago and it continues to be an important characteristic.⁸³

⁷⁵ American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, 'Report on the Comparison of S Corporations and Partnerships: Part I', (1991) 44(2) *The Tax Lawyer* 483.

⁷⁶ Mundstock, above n 73, 229.

⁷⁷ Yin and Shakow, above n 14, 106.

⁷⁸ For a discussion about the reasoning why the exclusion of non-residents for S Corporations does not breach the non-discrimination article see: John Taylor, 'An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation' (2006) 2(1) *Journal of the Australasian Tax Teachers Association* 30, 54. However, it is highlighted that this reasoning is not accepted by all: American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, above n 73. American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, 'Report on the Comparison of S Corporations and Partnerships: Part II' (1991) 44(3) *The Tax Lawyer* 813. For a discussion about the potential application of the non-discrimination clause to an imputation system see: Richard J Vann, 'International Implications of Imputation, Australian' (1985) 2(4) *Australian Tax Forum* 452.

⁷⁹ Taylor, above n 78, 55.

⁸⁰ Taylor, above n 78, 54-55.

⁸¹ Jesper Barenfeld, *Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations*, (2005), 105.

⁸² For example the LLC Agreement can allow greater flexibility in profit sharing arrangements.

⁸³ S Elias, *Contemporary Issues in Company Law* (1987).

Overly restrictive eligibility for transparency has the deleterious consequence of reducing the capacity of the business to raise equity. It is argued that such a limitation in the ICAA proposal is artificial and will lead to practices to circumvent the limitation anyway or alternatively to unduly exclude entities from being eligible. It is argued that the proposed eligibility requirements below provide sufficient flexibility to allow for the raising of equity while at the same time not compromising the integrity of the tax system.

The United States' circumstances provide an interesting comparison, as it has two transparent companies with vastly different eligibility requirements. McNulty, in the early 1990s, identified the enactment of LLC legislation across the United States as illustrating the need to liberalise S Corporations eligibility requirements.⁸⁴ Indeed, since this time, there has been liberalisation of the S Corporation's eligibility requirements in 1996⁸⁵ and 2004.⁸⁶ However, there is still a push for further relaxation with the proposed amendments of 2005 and 2006.⁸⁷ It is argued that a major justification for this relaxation for S Corporations in the United States is that it is hard to justify the different eligibility requirements for transparency between S Corporations and LLCs when they have similar underlying legal characteristics.

In this context, it is argued that the 2006 proposals did not go far enough in their liberalisation objective, and that both transparent company forms in the United States should be subject to the one standardised regime. This inconsistency is further highlighted by the fact that the Check-the-Box regulations allow certain foreign corporations to Check-the-Box and elect for transparency under Sub-Chapter K, whereas corporations formed within the United States are not entitled to do this. Many of these foreign corporations, such as an Australian private company, can have similar governance regimes and legal characteristics as an S Corporation. When viewed in this context, this inconsistency between domestic and foreign corporations is difficult to justify. Also, it should be noted that it is possible for a C Corporation to hold the membership interests in an LLC, whereas it cannot readily do so for an S Corporation.⁸⁸

It is argued that for tax transparency to be implemented, only three core eligibility requirements are required: non-public trading of membership interests;

⁸⁴ John McNulty, *Federal Income Taxation of S Corporations* (1992), 204.

⁸⁵ These are in addition to the reforms that occurred in 1981 and 1982. The 1982 reforms saw removal of the 80 percent foreign income restriction *IRC 1986* (US), s 1372(e); and specification that differences in transfer and voting rights did not create a second class of membership interest: *IRC 1986* (US), s 1361(c)(4). In 1996, certain trusts were allowed to hold membership interests and S Corporations were able to hold 100 percent of subsidiary corporations: *IRC 1986* (US), s 1361(b)(3)(B), known as QSSS.

⁸⁶ The 2004 amendments included allowing some bank trading activity, the creation of employee stock ownership plans, and providing for the increase in membership number to 100: *IRC 1986* (US), s 1361(b)(1)(A), with the aggregation of family members in this count: *IRC 1986* (US), s 1361(c)(1)(B).

⁸⁷ The proposed 2005 amendments are in *S Corporation Reform of 2005 Bill* (US), which was before the House Committee on Ways and Means.

⁸⁸ In the circumstances that the C Corporation holds all the membership interests in the LLC, then the LLC would be a disregarded entity, meaning all of the LLC's activity is treated as the C Corporation's; this saves doing annual tax consolidations, and can allow for tax free re-organisations when another corporation is acquired. The new corporation can acquire the LLC's assets in exchange for shares in the holding corporation.

election for transparent status; and cross-jurisdiction status.⁸⁹ An optional fourth requirement could be further specified, that being the condition pertaining to one class of membership interest. These core requirements are in addition to any loss restriction rules that apply in relation to members utilising allocated losses. Each of these core eligibility requirements is now discussed.

Similar to the ICAA proposal, the first core eligibility requirement argued for is the non-public trading of membership interests. In considering this issue, it is informative to consider the listing of membership interests on an exchange, such as through an initial public offer (IPO).⁹⁰ When an entity lists, the number of members can be very large. However, both S Corporations and LLCs are prevented from making IPOs if they wish to retain transparency. This is because S Corporations would find it difficult to ensure that the strict eligibility requirements are satisfied — such as having only resident members and not exceeding 100 members.

The exclusion of publicly traded partnerships from being able to Check-the-Box for transparency prevents an LLC undertaking an IPO.⁹¹ Indeed, for a LLC and its members to rely on safe harbour provisions made pursuant to regulations it is prudent that the number of LLC members is restricted to 100.⁹² Accordingly, there is some consistency between S Corporations and LLCs within the United States, with membership limited to 100 for tax transparency. However, these are enumerated under different Sub-Chapters of the *IRC 1986* (US).⁹³

In the United Kingdom, the laws pertaining to the LLP do not have an upper limit on the number of its members.⁹⁴ This does not mean, however, that an

⁸⁹ It is argued that a number of the eligibility requirements for S Corporations and LAQCs do not in themselves justify exclusion from tax transparency; instead, other 'general' mechanisms in the tax system should be able to adequately deal with the underlying concerns that the eligibility restrictions represent. For example, the prohibition of non-resident members could be adequately covered through the implementation of withholding tax rules on income allocations. Indeed, this is the mechanism used for LAQCs, LLCs and LLPs. Eligibility requirements that purport to exclude certain trading activities or asset holdings should be subject to an overall consistent tax system, and if adequate loss restriction rules are utilised then any trading activities should be allowed.

⁹⁰ Such an IPO can provide for a larger pool of equity funds and liquid market for transfer of membership interests.

⁹¹ *IRC 1986* (US), s 7704.

⁹² *IRC 1986* (US), s 7704. An example of a 'publicly traded partnership' under section 7704 is one which has partnership interest that are either (a) traded on established securities markets, (b) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded (Treasury Regulation, s 1.7704): (a) all interests issued in a transaction/s are not registered under the Securities Act of 1933, and (b) there are not greater than 100 members during the year. A partnership deriving greater than 90 percent of income from passive income will be excluded from being publicly traded: *IRC 1986* (US), s 7704(c) & (d).

⁹³ Of course it is possible for this cap to be circumvented with transparency being retained. For example, family members within six generations are counted as one for S Corporations. For an LLC, it would be possible to argue that there is no secondary market for its membership interest even though the membership exceeds 100.

⁹⁴ The absence of an explicit upper limit compares favourably to the previous limit of 20 members which was imposed on general partnerships and limited partnerships. Louise Pinfold (ed), *Tolley's Tax Planning 2005-06*. Vol. 1 (2005), 1346. Another potential restriction for LLPs raising equity is that a 'person' may be an LLP member, meaning individuals, corporations, other LLPs, or some other form of corporate entity can be LLP members: *Interpretation Act 1978* (UK), 'Person' includes an incorporated body of persons. However, the Registrar does not accept an unincorporated body such as a trust or general partnership being an LLP member, and requiring

LLP is able to offer its membership interests (or other securities) to the public, either directly or indirectly, as this can be an offence — unless certain procedures are complied with.⁹⁵ There are some current examples of LLPs being utilised for widely held operations, particularly as property investment vehicles, as well as for very large professional firms of solicitors and accountants.⁹⁶ Corresponding to the ICAA proposal, in New Zealand the LAQC's eligibility restriction of five members would likely prevent an IPO of membership interest in any meaningful way.

Across the jurisdictions studied, the restriction applying to membership ranges from five to 100, and to unlimited. Even with the potentially large number of members in the United Kingdom, there is a concern in all of the jurisdictions studied about when transparency is extended to publicly listed business forms. However, it should be recognised that these restrictions do not prevent a transparent company from listing their bonds on an exchange, thereby raising debt finance.⁹⁷ Part of the rationale behind these restrictions could include the administrative difficulties inherent with transparent treatment in widely-held circumstances.⁹⁸ This includes problems in relation to the collection of tax from a large number of members instead of just one entity; or the consequences pertaining to later amendments to taxable income for a year. However, given advances in technology these difficulties have diminished. For example, in each of the jurisdictions full and partial transparent forms have been used for collected investment vehicles.⁹⁹

Even without quantum restrictions, tax transparency itself could be a natural inhibitor to very large memberships. This is because it is uncertain whether a large number of members would agree to transparency, particularly if they are being assessed on unpaid profit allocations. It is understood that for publicly listed trusts in Australia, which have partial income transparency, this is dealt with by having quarterly distributions to members.¹⁰⁰ It is argued that allowing members to choose whether to have tax transparency or not may be a preferable inhibitor, rather than picking an arbitrary number, which may be circumvented in any event.

members to have their own legal personality: John Whittaker, John Machell and Colin Ives, *The Law of Limited Liability Partnerships* (2nd ed 2004), 14.

⁹⁵ For example a public corporation can offer membership interests publicly provided it has, amongst other things, a minimum membership capital of at least £50,000. Under reforms in the *Companies Bill 2006* (UK), it will no longer be a criminal offence, with instead penalties and the corporation required to register as a public corporation or be struck off.

⁹⁶ In the *Cabvision* case there was a plan for an LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests: *Cabvision Limited v Feetum, Marsden and Smith* [2005] EWCA Civ 1601 (20 December 2005), [15]. The United Kingdom Government has been concerned about LLPs being used in this way and has brought in a number of counter provisions.

⁹⁷ *IRC 1986* (US), s 7704 is not triggered if a business has only publicly traded debt. Richard Booth, 'The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships' (1997) 32 *Wake Forest Law Review* 79, 81.

⁹⁸ CE McLure, *Must Corporate Income Be Taxed Twice? A report of a conference sponsored by the Fund for Public Policy Research and the Brookings Institution* (1979).

⁹⁹ For example in the United States there is partial transparent treatment given for publicly traded oil and energy trusts.

¹⁰⁰ Michael Brown, *Collective Unconscious: It's time to examine collective investment vehicles*. Paper read at Business Tax Reform – Meet the Critics, Sydney (28-29 September 2006).

An argument against tax transparency applying when membership is widely held is that the theoretical reason for transparency may be weaker as there is a greater distribution of membership, with a separation between management and members. In widely-held circumstances, members are more akin to passive investors, who are unlikely to be involved in the management of the business.¹⁰¹ Therefore, in widely-held circumstances, an entity or an integrated tax system may be preferable.¹⁰²

In view of the above analysis, it is argued that no quantum on membership numbers is required to allow for transparency and instead, at most, the restriction should exclude membership interest in the transparent company being publicly traded. However, there may be some merit, indeed, in allowing transparency to both publicly and non-publicly traded entities.¹⁰³ An advantage of having no quantum restriction on membership, is that membership interests may be issued to employees to reward employees for their effort and loyalty. Such employee membership interests can be critical in the start-up phase when cash is a limited resource.

The second core eligibility requirement that is argued for is an election for transparent status to be applicable. This is preferable given that members are assessed on the business's allocated income even though it is unpaid. This tax liability for the business income could be seen as an exception to the normal legal notion that members are not liable for the debts of the transparent company.¹⁰⁴ Such a consent mechanism also alerts members to their obligations and may, in a logistical context, assist the tax authority in the collection from them. It is argued that this election mechanism is more appropriate to deal with unpaid allocations compared to the 'one class' of membership interest.¹⁰⁵

The ICAA proposal does highlight the potential problems that can arise in respect of members having to pay tax on their unpaid allocations. It nevertheless concludes that this is better dealt with internally by the business' operating agreement rather than to be externally mandated in tax rules.¹⁰⁶ The ICAA proposal suggests that the election for flow-through requires a unanimous member election.¹⁰⁷

There are several election mechanisms extant in the jurisdictions studied. In terms of S Corporations, this includes the initial unanimous member election. However, an incoming member must accept an existing S Corporation election, unless the incoming member acquires greater than 50 percent of membership interest.¹⁰⁸ Alternatively, in the context of election mechanisms for LLCs, members' consent to tax transparency depends upon the LLC's Operating

¹⁰¹ Although non-active members may be adequately dealt with the differentiation between passive and active losses.

¹⁰² Harris, above n 29, 44.

¹⁰³ Of course, a large consideration would be the administrative feasibility of transparency applying to a publically traded entity.

¹⁰⁴ It is argued that if not for tax transparency, it would be the transparent company as a separate legal entity that would have the resulting tax liability to the relevant Tax Office.

¹⁰⁵ It has been argued that the eligibility requirement for having 'one class' of membership interest is potentially a way to address the problem of unpaid allocations in terms of fairness: Taylor, above n 76, 49.

¹⁰⁶ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.8.5].

¹⁰⁷ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.9.3].

¹⁰⁸ *IRC 1986* (US), s 1362(d)(1)(B).

Agreement to determine how tax elections are to be made. Pursuant to the *Revised ULLC Act 2006* this is likely just to be a majority decision.¹⁰⁹ For an eligible LLP there is no election mechanism, as tax transparency applies automatically in the United Kingdom when it is eligible. The election for LAQC status in New Zealand can either be unanimous or a majority election.¹¹⁰ Manager elections have similar percentages as to member elections.

Given the above analysis of the various mechanisms, it is argued that for tax transparency to apply it is sufficient that a majority election, as opposed to unanimous, by the members (and managers if separate to members) be made. Any oppression of minority members that might result because of unfunded tax liabilities would be better dealt with under regimes provided by the relevant governance regimes, rather than adding tax rules that duplicate or vary those existing governance regimes.

The third core eligibility requirement argued for is the consideration of cross-jurisdictional treatment.¹¹¹ To enhance cross-jurisdictional treatment and to limit the potential tax arbitrages of a foreign business form, it is argued that transparency should be extended to non-resident business forms only if they are treated as a transparent entity in their jurisdiction of residence, so that the business form is transparent in both jurisdictions. Such a rationale underpins the recent Australian CFC hybrid amendments.¹¹² This requirement could assist in reducing asymmetrical treatment of transparent companies, as well as reducing the potential for tax arbitrages.¹¹³ Additionally, such symmetry could reduce the potential complexities that may arise with cross border transactions.¹¹⁴ The ICAA proposal does not canvass the issue of foreign entities electing for transparency, which may be due from its focus on micro businesses and the assumption that they would be domestic firms.

It has so far been argued that the eligibility requirements for tax transparency should be non-listing of membership interest; the requirement of majority member/manager election; and the condition that foreign entities be required to have symmetrical treatment in their resident jurisdiction. In addition to these three core eligibility requirements, it may be preferable to provide an optional rule that if the transparent company has one class of membership interest, then certain tax integrity measures will not apply. This is predicated on the

¹⁰⁹ *Revised ULLC Act*, s 407(b)(2). In the absence of a contrary LLC Agreement, the default rule provides members of a member-managed LLC with equal rights in decisions.

¹¹⁰ *ITA 2007 (NZ)*, s HA 29. Such a majority election would be automatically revoked when a majority member becomes a minority member, or alternatively when a minority member obtains a majority of shares. To determine whether a majority election can be made the member's effective interest in a corporation is measured by the percentage of decision-making rights carried by the shares (and options) in a corporation in relation to dividends (or other corporation distributions) plus corporation constitution, variation of the corporation's capital and director appointments or elections: *ITA 2007 (NZ)*, s HA 43.

¹¹¹ There appears to be no reason why a non-resident entity should not be eligible to elect for transparency. Any concerns with the diversion of income offshore could be addressed with the requirement to lodge an information return detailing activities, which is done for all transparent entities except a single member LLC.

¹¹² *ITAA 1997 (Cth)*, Div 830.

¹¹³ Philip Postlewaite, 'Treasury creates a monster. Australia, beware the hybrid entity!' (2006) 16 *Revenue Law Journal* 156. However, this may sufficiently be dealt with by Double Tax Agreements, particularly if they have transparent company provision.

¹¹⁴ Brett Freudenberg, above n 3.

argument that a transparent company with only one class of membership interest may have the effect of decreasing the overall complexity,¹¹⁵ because integrity measures addressing potential streaming of income and/or losses will not be applicable.¹¹⁶ For example, a benefit of providing for one class of membership is that it can provide a simpler basis to determine the allocation of profit and/or losses members.¹¹⁷

The ICAA proposal does not include a requirement for one class of membership interest; instead it outlines that profit and losses should be distributed based on a proportional entitlement to profit, similar to the CFC hybrid amendments.¹¹⁸ The ICAA proposal also advocates largely that rollover rules that apply to general partnership revenue assets should be extended to the flow-through entity.¹¹⁹

It is argued that it is preferable to provide a safe harbour for a transparent company with only one class of membership interest. If a transparent company has more than one class of membership, then, and only then, additional rules should apply addressing streaming issues. In this way, members could elect the degree of complexity to apply.¹²⁰ Of course, one class of membership interest would in turn (conversely) decrease the flexibility of distributions and may increase the overall tax burden.

As an illustration of the above contention, in the early phase of a firm's development a simple capital structure of one class of membership interest may be perfectly adequate. However, for subsequent raising of equity, different classes of membership interest may be necessary. This flexibility thereby allows the organisation both institutionally and structurally to expand. Further, the proposed eligibility restrictions allow for sophistication of membership interest, though they also may nevertheless impose additional integrity measures. In this way, the business can choose the level of tax complexity that may potentially result from raising additional equity.

Of course, the requirement for one class of membership need not be explicit, because if one class did exist then *quid pro quo* integrity measures aimed at streaming should not apply.¹²¹ If such streaming rules do exist, by having one class of membership as an explicit exclusion highlights the additional complexity

¹¹⁵ The findings of DeLuca et al. partly support this assertion: Donald DeLuca, Arnie Greenland, John Guyton, Sean Hennessy and Audrey Kindlon, *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, Washington DC (7-8 June 2005).

¹¹⁶ Also revenue asset rules for disposal of membership interest need not apply when one class of membership interest exists. Freudenberg, above n 24.

¹¹⁷ For example, with S Corporations and LAQCs, allocations to members are determined by considering the number of days that members have held their interest and the percentage of their membership interest: James S Eustice, 'Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals)' (1983-1984) 39 *Tax Law Review*:345, 362.

¹¹⁸ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.10.6].

¹¹⁹ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.18.4] (depreciating assets), [3.18.6] (trading stock) and [3.18.9] (work-in-progress).

¹²⁰ This option may be preferable for capital intensive industries, as they might want to stream tax preferences to certain members.

¹²¹ Note it has been questioned whether streaming rules are necessary at all. If streaming rules were excluded from a tax system, then it is likely that complexity of the tax system would be decreased by one class of membership. Freudenberg, above n 24.

that having greater than one class would involve. In terms of the Australian CFC hybrid amendments, streaming is dealt with by members' allocations for tax purposes based on an overall percentage.¹²² Additionally it is argued that these eligibility requirements may alleviate some of complexity issues that can arise with tax transparent companies.¹²³

V OVERALL TAX BURDEN

If tax transparency can decrease or defer the income tax burden then this could help alleviate closely held businesses' financing problem. A lower tax burden would allow members to reinvest profits into the business, thereby reducing the necessity to seek and obtain external debt financing or alternatively equity investment.¹²⁴ Also, if tax transparency does improve the neutrality between debt and equity financing, then this could assist closely held businesses, which have historically been more reliant on equity funding than on external debt for financing.¹²⁵ It is argued that if tax transparency does not operate in this way, it is questionable as to the extent to which tax transparency would assist closely held businesses.¹²⁶

It has been previously demonstrated the role a jurisdiction's tax system performed in the context of the introduction of the transparent companies studied.¹²⁷ For S Corporations and LAQCs it was shown that the objective was to improve tax neutrality between general partnerships and closely held corporations. It was also suggested that transparency applying to S Corporations and LAQCs could be perceived as a 'carve out' from the normal corporate tax treatment. For the introduction of LLCs and LLPs, breaches of tax neutrality tended to motivate taxpayers to lobby for the introduction of a new business form — one that was subject to tax transparency provided to general partnerships.

Similar to Australia, in considering the foreign experience the utilisation of transparent companies does not guarantee an overall lower tax liability, because there are inevitably qualifications and exceptions. Indeed, in some circumstances, transparent treatment can increase members' tax burden. Nevertheless, there is significant potential for tax savings with transparent companies — particularly with access to losses, tax preferences and capital gains.¹²⁸ The significance of these implications is analysed below. In addition to this analysis, consideration is

¹²² *ITAA 1997* (Cth), s 830-30.

¹²³ Restrictive eligibility requirements may adversely impact on compliance costs; the complexity of a transparent regime could be mitigated as well as allowing for the greater potential to raise equity finance by adopting the above criteria for transparency eligibility. It is asserted that these conditions should be the core requirements for eligibility for transparency; other concerns could be adequately dealt with by general tax provisions, such as withholding tax applying to allocations to non-resident members. See: Freudenberg, above n 3.

¹²⁴ An incentive for members to contribute equity to a transparent company is that generally this would allow them greater utilisation of allocated losses. See: Freudenberg, above n 24. Also for some transparent companies a greater membership cost basis means that distributions to them from the transparent company are tax free.

¹²⁵ Johns et al., n 42, 110. Also, tax transparency can improve the tax neutrality between debt and equity funding: Bevin, above n 29, 96, and Bird, above n 28, 235.

¹²⁶ Of course there could be other salient reasons, such as flexibility of governance rules and liability protection.

¹²⁷ Freudenberg, above n 36.

¹²⁸ This may be enhanced by streaming and the splitting of income.

accorded to assessment of unpaid allocations, as well as to the status of active members.

A Assessment for unpaid allocations

A potential adverse implication of tax transparency is the assessment of members for allocated income, in spite of the fact that there has been no distribution from the transparent company to them. This applies to members of S Corporations, LLCs and LLPs.¹²⁹ Furthermore, with such an unpaid allocation, a member's tax rate could be higher than that applying to corporations and, hence, the allocation could result in a higher overall tax burden.

This is an important consideration given the trend worldwide to lower the tax on capital, including corporate rates.¹³⁰ While there is also a trend of lowering personal rates, these are still normally higher than the corporate rates.¹³¹ This is important, as the corporate form can be used to 'shelter income' at a lower rate. In those jurisdictions studied, the United States' Federal top personal marginal tax rate is equivalent to the top corporate tax rate of 35 percent.¹³² In the United Kingdom the top personal tax rate can be either 40 or 32.5 percent depending upon the type of income, with the corporate rate recently reduced from 30 percent to 28 percent.¹³³ In New Zealand, the corporate rate is 30 percent from 1 April 2008 (reduced from 33 percent), whereas the top personal marginal tax rate is currently 39 percent.¹³⁴

Similarly a negative factor with a tax transparent company in Australia is the relationship between the corporation and the individual tax rates in Australia. The tax benefits of transparency in Australia are eroded by the full imputation system applying to corporations and by the lower corporate tax rate of 30 percent, compared to the top individual marginal tax rate of 45 percent plus 1.5 percent Medicare levy. This means the allocation of income to members of an Australian transparent company could be subject to a greater rate of tax compared to profits accumulated in a corporation. With current income tax brackets for individuals, once tax income exceeds \$120,000 on average the sheltering of income within a corporate structure can be preferable.

¹²⁹ Note the decision of *Knott v Commissioner United States Tax Court*, 1991. 62 T.C.M. 287 confirmed that the income of an S Corporation need not be distributed in order to be included in the taxable income of the member.

¹³⁰ Steffen Ganghof and Richard Eccleston, 'Globalisation and the Dilemmas of Income Taxation in Australia' (2004) 39(3) *Australian Journal of Political Science* 519.

¹³¹ Mark Hallerberg and Scott Basinger, 'Internationalization and Changes in Tax Policy in OECD Countries: The Importance of Domestic Veto Players' (1998) 31(3) *Comparative Political Studies* 321, 321.

¹³² *IRC 1986* (US), s 199. While currently in the United States there is some alignment between the corporate tax rate and the maximum individual tax rate, prior to the 1986 tax reforms the corporate rate was lower than the individual rate; with the 1986 tax reforms this was reversed until 1993. From 1993 to 2003 the corporate tax rate was lower than the individual rate, and equalled it from 2003. Note from 2005 a corporation may be entitled to reduce tax rate, as all businesses can get a 3 percent of the qualified amount, up to 9 percent for a domestic activity deduction.

¹³³ Starting in the 2008 year. Note there are proposals to increase the rate of income tax to 45 percent for those taxpayers with income greater than £150,000 (from 6 April 2011).

¹³⁴ In New Zealand, when LAQCs were first introduced there as an alignment between the individual and corporate tax rate at 33 percent.

This may mean that the adoption of such a fully tax transparent company could increase the overall tax burden and thereby reduce the incentive for the utilisation of a transparent system. After all it was the lack of perceived benefits that undermined the utilisation of the Simplified Tax System in Australia.¹³⁵

In contrast, the profits of New Zealand's LAQC are not automatically allocated to members; this is because it is a partial loss transparent company rather than a fully transparent company. This means an LAQC's income is initially assessed at the entity level at 30 percent.¹³⁶ Only when a member receives a franked dividend from an LAQC will the member include the dividend in their assessable income,¹³⁷ together with the imputation credit.¹³⁸ The LAQC member is then able to offset their tax liability with the imputation credit.¹³⁹ This mechanism allows for the accumulation of taxable income in the business form at a lower rate of tax.

Another implication is that the direct allocation of profits to members means that the capital growth in the business may be taxed as 'income' to members on a regular basis, rather than on the disposal of the membership interest.¹⁴⁰ To the extent that income is allocated to members, they would not be able to access the concessional treatment that can apply to capital gains in the various jurisdictions. From an economic perspective, this can be considered appropriate, as members' annual assessment more accurately reflects their increase in wealth due to the business operations. This contrasts with the position of deferral of profits available when the business form is subjected to an entity or integrated tax treatment, with members not assessed on growth until the consequent sale of their membership interest, which then could be concessionally taxed as a capital gain.¹⁴¹

However, despite the foregoing analysis, tax transparency does not result in a full assessment of economic wealth. Appreciating capital assets that are held by the transparent company are not assessed to members until the gain is realised through the disposal of the underlying asset. In this circumstance, members of a transparent company would receive the benefit of deferral, as well as the concessional CGT treatment.

¹³⁵ Mark Burton, 'The Australian small business tax concessions - public choice, public interest or public folly?' (2006) 21(1) *Australian Tax Forum* 71.

¹³⁶ An imputation system applies to the LAQC and other New Zealand corporations. For New Zealand tax purposes the definition of 'company' also includes a 'unit trust', so unit trusts are subject to an imputation system also: *ITA 2007* (NZ), s YA 1. Sole proprietors, general partnerships and trusts (apart from unit trusts) are taxed on a flow-through basis. This means that the payment of corporate tax is recorded in the LAQC's imputation credit account: *ITA 2007* (NZ), s OB 4.

¹³⁷ The imputation credits are then attached to the dividends paid out: *ITA 2007* (NZ), s OB 30. The LAQC must impute any dividend payment to the fullest extent possible, known as a franked dividend: *ITA 2007* (NZ), s HA 15. This is similar to what previously operated in Australia before the implementation of the new franking rules from 2002.

¹³⁸ *ITA 2007* (NZ), ss HA 14 and HA 15.

¹³⁹ *ITA 2007* (NZ), ss HA 14 and HA 15. Note in New Zealand the correct term is 'fully imputed dividend', but to ensure consistency within this dissertation the term 'fully franked' has been used. For an individual on the top marginal rate (39 percent) an effective additional nine percent tax rate would apply to the receipt of a fully franked dividend.

¹⁴⁰ Each year the profits of the transparent company are directly assessed to members as either income or capital.

¹⁴¹ Of course income derived by the business form would be subject to tax, which could be below or above the member's tax rate.

Also, the assessment of members on allocated income could put pressure on a transparent company to distribute money to enable members to fund their respective tax obligations, which then (in turn) could generate cash flow problems and organisational instability.¹⁴² However, if members are active in the management of the transparent company, then they can in this capacity determine the timing and quantum of distributions. For example, a distribution to a member could be purely to fund the member's tax liability amount and not (to fund) the full allocation. A related issue is how 'unpaid allocations' could affect the ability of members to use allocated losses.¹⁴³

B Access to losses and tax preferences

With all the transparent companies studied, a discernible advantage over corporations subject to an entity or integrated tax system is that losses are allocated directly to members. For corporations in the jurisdictions studied, losses are 'trapped' at the entity level, to be carried forward to offset future income earned by the corporation.¹⁴⁴ With transparency the allocation of losses directly to members can enable members to offset these losses against other assessable income. This has the overall effect of reducing members' aggregate tax burden. Of course this is subject to the proviso that the relevant loss restriction rules are satisfied.¹⁴⁵

The value of losses can deteriorate with the time value of money and hence the timelier utilisation of losses will be beneficial for members. Additionally, losses at the member level may shelter income which would otherwise be taxed at a higher rate rather than that applying at the corporate level. The ICAA proposal advocates the allocation of losses directly to members, but subjected to a loss restriction rule based on the venture capital incorporated limited partnership rules.¹⁴⁶

A related issue to losses is the ability of members to access tax preferences when transparency applies. Tax preferences describe amounts or receipts that are not included in a taxpayer's (including a business form) taxable income.¹⁴⁷ When an entity or integrated approach applies, normally the distributions to members of profits that have been sheltered from tax, in effect, are 'clawed back', thereby resulting in members being fully assessed on the previously untaxed profit. In contrast, tax transparency can allow for tax preferences to flow through to members, thereby resulting in an overall lower tax burden. In the United States

¹⁴² Joint Committee on Taxation, Present Law and Background Relating to Selected Business Tax Issues. (2006), 10.

¹⁴³ Freudenberg, above n 24.

¹⁴⁴ For example in the United States if C Corporations have net operating losses not absorbed by their taxable income in the two preceding years, the losses may be carried forward for up to twenty years to be applied against assessable income: *IRC 1986* (US), s 172. In the United Kingdom any losses realised by a corporation are trapped at the entity level and cannot be allocated to members.

¹⁴⁵ Freudenberg, above n 24.

¹⁴⁶ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.15.6].

¹⁴⁷ These tax preferences may arise due to various taxation rules. For example, tax preferences in Australia could arise due to research and development concessions, exempt income, asset revaluations, capital gains concession (such as the CGT asset being acquired prior to 20 September 1985 in Australia), capital works, accelerated depreciation for plant and equipment, small business concessions, environmental expenditure deductions, water care deductions, or amounts sheltered because of carried forward losses.

context, an advantage that LLCs have over S Corporations is the ability to direct these tax preferences, through special allocations, to certain members.¹⁴⁸ However, such streaming is not unrestrained, with special allocations likely to be restricted to a member's capital account.¹⁴⁹

Even in the case of the partial loss transparent company studied — the LAQC — the treatment of unfranked dividends paid out to members enable members to access tax preferences.¹⁵⁰ In effect, unfranked dividends represent profits of the corporation that have not been subject to tax at the entity level. For an LAQC member, the receipt of an unfranked dividend is regarded as exempt income and not assessable.¹⁵¹ The major tax preference in New Zealand is the absence of a comprehensive CGT. In comparison, when a New Zealand corporation distributes profit realised through the sale of a capital asset, this would normally be as an unfranked dividend which is fully assessable to the member.¹⁵² The ICAA proposal would allow tax preferences to flow-through to members, as opposed to the claw-back that generally occurs for corporations and their members in Australia.¹⁵³

C Capital gains

A potential benefit of transparency is that it can more clearly avoid the perceived double layer of taxation that can occur in respect of appreciated assets when an entity approach is adopted. Vann has demonstrated that this 'double taxation' of capital gains is incorrect provided that the value of the membership interest is based on retained profits.¹⁵⁴ However, it should be appreciated that such a valuation will not always be the case. If an appreciated asset¹⁵⁵ is sold by a corporation, subject to an entity tax system, then the corporation is likely to be subject to tax on that sale. If the profit from this sale is then distributed, members

¹⁴⁸ This means that amounts could be allocated to LLC members who can better utilise the tax preferences.

¹⁴⁹ Treasury Regulation, s 1704-1(b)(2)(ii)(b),(d). For such special allocations to be effective the LLC's Operating Agreement must provide for it and the allocations must have 'substantial economic effect': *IRC 1986* (US), s 704. Also there is a restriction on special allocations of deductions attributable to LLC's non-recourse outside loans: Treasury Regulation, s 1.752-1(a)(2): Indebtedness secured by partnership property for which no partner bears personal risk. Treasury Regulation, s 1.704—2(b)(1).

¹⁵⁰ Note that any dividends received from a subsidiary corporation by an LAQC are assessable to the LAQC, as there is no exemption in relation to wholly owned subsidiaries. However, the LAQC would be entitled to claim any imputation credits attached to the dividends paid from a subsidiary, which may effectively eliminate any tax payable: Inland Revenue (NZ), above n 67, 41. This rule is considered necessary to prevent an LAQC receiving a dividend from a non-QC subsidiary on a tax-free basis, and then passing this out to individual shareholders with no further tax imposed.

¹⁵¹ *ITA 2007* (NZ), ss HA 16 and CW 15.

¹⁵² This would be assessed at their appropriate income tax rate without any imputation credit to offset the resulting tax liability.

¹⁵³ A noted exception to this is some of the provisions in *ITAA 1997* (Cth), Div 152. For unit trusts electing to be within the scheme, CGT event E4 would not apply to distributions of non-assessable amounts: *ITAA 1997* (Cth), s 104-70.

¹⁵⁴ Richard J Vann, 'Australia's Policy on Entity Taxation' (2001) 16 *Australian Tax Forum* 33, 38: "The example shows that in the simple case presented there is no double tax on retentions to the owner under the CGT to the extent that value is based on retentions (putting aside the problem of matching the dividends and the capital loss for the purchaser). Thus the double taxation of retentions is a myth".

¹⁵⁵ Appreciated asset is property that has increased in value.

are also likely to be assessed on the receipt of a dividend, although there could be some dividend relief. This dividend receipt would be income in nature even despite the fact that the underlying profit relates to the disposal of a capital asset. The dividend receipt as income restricts the ability of the member to access the concessional treatment that may be afforded to capital receipts. If instead a dividend is not declared and the member sells their membership interest, this sale is likely to be at an increased value, due to the appreciated property or profit held by the corporation. In this circumstance the member is also assessed on the capital growth, although the member is able to access CGT concessions.¹⁵⁶ In comparison, tax transparency can allocate the capital gain directly to the members, thereby resulting in clearly one layer of tax, as well as allowing members to access concessional CGT treatment.

In terms of the ICAA proposal for a transparent company in Australia, more of an 'aggregate' approach is advocated. This results from a greater reliance on the existing tax treatment for general partnerships,¹⁵⁷ with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.¹⁵⁸ Such treatment could inhibit the attraction of new equity as changes in membership can potentially trigger partial disposals.¹⁵⁹ This is similar to the United Kingdom's LLP,¹⁶⁰ although such treatment of capital gains has been described as a major advantage of the LLP, compared to the position when membership interests in a corporation are sold.

D Comparison to corporate tax treatment

While the comparison between corporate entity tax treatment and transparency is a multi-faceted issue, there is indeed the potential for tax transparency to decrease the overall tax burden. This will depend upon a number of factors, including whether the corporation is subject to an entity or integrated tax system, the relationship between tax rates, and the treatment of capital receipts and employment taxes.

As previously discussed, Australian corporations and their members are subjected to an imputation system. This means that income can be sheltered at the corporate level and once distributed can either be in the form of franked or unfranked dividends. While both dividend types are assessable to the member, franked dividends have attached franking credits which allow the member to decrease their tax payable.

Due to the United States' entity tax system, S Corporations and LLCs offer some tax savings to closely held businesses compared to the tax treatment

¹⁵⁶ Note however the incoming new member will have a greater cost basis due to the greater amount paid recognising the appreciated value of the asset held, thus diminishing the extent of this double economic taxation.

¹⁵⁷ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.18.1].

¹⁵⁸ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.18.2].

¹⁵⁹ Also in terms of revenue assets held, such as depreciating assets, trading stock and work in progress, changes in membership can cause disposal. However, there is the potential for rollover relief to disregard these disposals in certain circumstances: depreciating assets [*ITAA 1997* (Cth), s 40-340(3)]; trading stock [*ITAA 1997* (Cth), s 70-100(6)].

¹⁶⁰ One implication of LLP's tax transparent treatment is that members hold fractional interests in the LLP's assets, even though the LLP is a separate legal entity to the members: *LLP Act 2000* (UK), s 1; *Taxation of Chargeable Gains Act 1992* (UK), s 59A.

for C Corporations.¹⁶¹ While the extent of this saving has decreased since 1986, with the individual tax rate now equivalent to the top corporate tax rate of 35 percent, and capital gains and dividends being concessional tax, there are still potential tax savings.¹⁶²

There are a number of characteristics of the United Kingdom tax system that reduce the advantages of LLPs compared to the taxation of corporations. In the United Kingdom, corporations are assessed to a corporation's tax on profits under a separate act.¹⁶³ A corporation's assessed profits include both income and chargeable capital gains, with indexation available for capital gains.¹⁶⁴

In the United Kingdom the overall tax burden in effect is lower in a corporate scenario when there is accumulation and then disposal of membership interest. This contrasts with the situation where there are yearly distributions which produce a higher tax burden, even with the notional dividend credit system that applies.¹⁶⁵ This accumulation advantage of the corporation is enhanced by the fact that, prior to disposal of membership interest, tax liability was lower, thereby providing a timing advantage. This can mean disregarding the imposition of

¹⁶¹ C Corporation members are not assessed on corporate profits until profits are distributed via dividends to them. When dividends are paid an entity tax system applies, with the member assessable on the dividend with no credit for tax paid at the corporate level. In terms of an individual member, normally marginal tax rates would apply up to 35 percent on the receipt of such dividends. However, there is temporary tax relief for the receipt of dividends by a member: a 15 percent rate applies until 2010: *IRC 1986* (US), s 1(h)(11) introduced by the *Jobs and Growth Tax Relief Reconciliation Act (US) 2003* (passed May 2003). This reduces the top capital gains tax and dividend tax rate to 15 percent (or 5 percent for low income families and 0 percent for the 2008 year only) for the period 1 January 2003 to 31 December 2008. This has now been extended to 2010 through the *Tax Increase Prevention and Reconciliation Act 2005* (US).

¹⁶² However, it should be appreciated that the extent of 'double taxation' for C Corporations and their members can be mitigated through a number of mechanisms. For example the payment of the following deductible amounts by C Corporations to members could also achieve a single layer of taxation: wages, royalties, rent and interest on loans. Also the C Corporation could make contributions to a pension fund established for the member. Alternatively, C Corporations could retain profits and members could realise their increase in wealth as a capital gain through the sale of their membership interest, which facilitates deferral and potential concessional tax treatment. If this transfer of membership interest occurs through inheritance at death then tax can be avoided altogether, as the heir is entitled to a step up in the membership cost basis to the fair market value.

¹⁶³ *Income and Corporation Taxes Act 1988* (UK), s 6(1): A corporation which is resident in the United Kingdom is chargeable to corporate tax in respect of all its profits wherever arising. United Kingdom resident corporations are, however, not liable in respect of dividends received from other United Kingdom resident corporations.

¹⁶⁴ *Income and Corporation Taxes Act 1988* (UK), s 6(4). For the 2008 year the first £300,000 profit of a corporation is assessed at 21 percent; for profits in excess of £1.5 million, the rate is 28 percent. *Finance Act 2002* (UK), s 30. Prior to 2008 the corporate tax rate was 30 percent. Before 6 April 1999, corporations making distributions had to pay advanced corporation tax as part of the United Kingdom's imputation system. The rate between these two figures is 30 percent less an amount to ease the transition to the highest rate, using a fraction. From 2002 to 2006 there was a special rate that applied to small corporations, but this has been abolished: Freedman, above n 44, 325.

¹⁶⁵ The United Kingdom now has a notional dividend tax credit system, this being a form of integration for corporate distributions. This requires a corporation to pay an additional tax (known as the non-corporate distribution rate) when a corporation has an underlying rate of tax less than 19 percent and it makes a distribution to a person not a corporation. *Income and Corporation Taxes Act 1988* (UK), s 13AB inserted by *Finance Act 2004* (UK), s 28, Schedule 3, paragraph 2. Applies from 31 March 2004. If a corporation member disposes of their membership interest, this could result in a chargeable gain to the member. However, CGT taper relief could reduce the burden of this.

employment taxes, the tax payable through an LLP can be greater compared to corporation.

In New Zealand, the relationship between LAQCs and other corporations is more closely aligned, due to the LAQC being a partial loss transparent company and a full imputation system applying to corporations. Indeed there is largely tax equivalence between LAQCs and corporations in New Zealand, unless there are tax losses or tax preferences. There is no overall tax burden difference between the LAQC and a corporation when there are no tax preferences with all earnings assessable and where these after-tax profits are distributed to members.

E Active members

Prior research has illustrated that members of closely held businesses are likely to be active in the business.¹⁶⁶ In the jurisdictions studied, there are issues pertaining to the tax treatment of active members and, in particular, whether they should be treated as self-employed or as an employee. Such status can influence the overall level of tax payable. Sometimes it can be tax favourable and other times not.

In the Australian context, the ICAA proposal suggests that active members would be treated as self-employed rather than as employees, thus removing the application of fringe benefits tax to benefits provided to active members.¹⁶⁷ The ICAA proposal suggests that the treatment of active members as self-employed will reduce compliance costs due to the non-application of fringe benefits tax (FBT) to benefits provided to them. However this fails to appreciate that some fringe benefits are concessionaly taxed and have been used by active members through their business structures to reduce their tax impost. Indeed the Australian government has introduced provisions to restrict this ability due to concerns of abuse.¹⁶⁸

How have the foreign jurisdictions studied addressed active members? For an active member, the S Corporation can be advantageous when compared with that of a member of an LLC in the United States.¹⁶⁹ In the United Kingdom, the LLP can be particularly advantageous for active members when compared to corporations. Equally, New Zealand's LAQC can be advantageous compared with general partnerships. Given the variations, this raises the issue of should be the appropriate treatment for an active member of a transparent company.

¹⁶⁶ Harris, above n 29, 47.

¹⁶⁷ Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.21.1]. However, the ICAA proposal highlights that this status may not be recognised by various state governments in the application of payroll tax and workers compensation. Accordingly, when there are different levels of governments, it is preferable that a consistent approach is utilised.

¹⁶⁸ For example, the personal services income provisions disregard the business form for tax purposes and allocate the income and or losses directly to the member performing the personal services. The operation of these provisions restrict taxpayer's ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. *ITAA 1997 (Cth)*, s 86-15.

¹⁶⁹ The potential savings offered by the two transparent companies in the United States is not equivalent. There are numerous differences in their precise treatment, including tax implications for contributions or distributions of assets between members and the transparent company, the ability to stream allocations and the application of employment taxes.

For the United States' transparent companies, when members are active in the business, income allocations, member wages and fringe benefits can be treated differently. In terms of the tax treatment of an S Corporation, it is possible for the member to be regarded as an employee, even if the member owns 100 percent of the membership interests in the S Corporation. This situation denotes 'entity acknowledgement' for the S Corporation and its active members, because the S Corporation is acknowledged as a separate legal entity to the member, thereby enabling it to be the employer of the member. In view of this, wages that are paid to an active member for work should meet standards of reasonable compensation and this would then be an allowable deduction for the S Corporation. For the member, such wages would be assessable income. However, in addition to income taxes, in the United States wages paid would be subject to employment and social security taxes (employment taxes), which amount up to an additional 15.3 percent.¹⁷⁰

In comparison to 'wages' paid to an active member, business 'income' that is allocated to S Corporation members while assessable to them, it is, however, not subject to employment taxes.¹⁷¹ The imposition of employment taxes on wages paid to members may encourage the payment of lower wages to active members, with the balance being taken out through higher allocations of income to members.¹⁷²

Unlike S Corporations, an LLC member usually does not qualify as an employee of the LLC for tax purposes. Instead more of an aggregate approach is utilised, with an LLC member treated as self-employed.¹⁷³ That is, the LLC is not recognised as a separate taxpayer from its active member and, consequently, a member cannot then be employed by him or herself. This has the resultant consequence that the entire allocation of income to an LLC member (including guarantee amounts)¹⁷⁴ is likely to be regarded as self-employment income, and is

¹⁷⁰ Such as employment taxes, federal social-security taxes (FICA), Medicare taxes, interest and penalties. *IRC 1986* (US), ss 1401 and 3101 impose self-employment tax on an individual's net earnings from self-employment. In 2005, the self-employment tax and combined social security tax rate was 12.4 percent on earnings up to \$90,000, and 2.9 percent on all earnings above that for hospital insurance. Specified types of income can be excluded, such as rentals from real estate, dividends, interest, capital gains and losses from timber, certain non-inventory mineral income and retirement payments: see Joint Committee on Taxation, *Additional Options to Improve Tax Compliance* (2006), 29.

¹⁷¹ Revenue Ruling 59-221, 1959-1 C.B. 225.

¹⁷² If there were lower wage expenses, then this would increase the transparent company's income, which the S Corporation would allocate to members for the taxable year. Also the elimination of the cap on hospital insurance could also encourage lower wages. Joint Committee on Taxation, above n 168, 32. The cap on hospital insurance component was eliminated by the *Revenue Reconciliation Act of 1993* (US); this means that paying hospital insurance tax on higher wages does not increase the individual's Medicare benefits. Note that self-employed persons can now deduct health insurance where previously they could not. This arrangement would not be effective if the S Corporation member's wages were not reasonable. However, what precisely is 'reasonable' is a malleable and difficult concept to quantify at times, and enforcement by the United States' IRS can be difficult due to factual determinations made on a case-by-case basis.

¹⁷³ James Boyd, D Larry Crumbley, Jon Davis, Steven Dilley, William Hoffman Jnr, David Maloney, Gary McGill, Mark Persellin, William Raabe, Boyd Randall, Debra Sanders, W Eugene Seago, James Smith and Eugene Willis, *Corporations, Partnerships, Estates and Trusts*. Edited by W. Hoffman Jnr, W. Raabe, J. Smith and D. Maloney (2005), 10-40.

¹⁷⁴ A guarantee payment is a payment for services performed by the members or for the use of the member's capital, usually expressed as a fixed dollar amount. Guarantee amounts would be

consequently subject to employment taxes.¹⁷⁵ Thus, in effect, this means that the entire LLC allocation could be subject to employment taxes in addition to income taxes. Contrast this situation with that pertaining to an S Corporation where, for the active member, only the reasonable wages paid to him or her are subject to employment taxes.¹⁷⁶

The United States Government is aware of the discrepancies in relation to the application of employment taxes between S Corporations and LLCs.¹⁷⁷ Research concludes that S Corporations might be a 'multi-billion employment tax shelter'¹⁷⁸ that is worth an estimated \$39 billion in lost tax revenue for the 2001 year.¹⁷⁹ Hence, there are current proposals on the political agenda designed to treat members as self-employed if the S Corporation conducts a 'service business'. For such service businesses, all allocations from an S Corporation would be subject to employment taxes like LLC members, although these are yet to be implemented.¹⁸⁰

A related issue here is the provision of 'benefits' to active members. Unlike with income allocations, there is greater consistency of fringe benefits provided by S Corporations and LLCs to members, and therefore greater tax neutrality. In terms of fringe benefits an aggregate approach is used, because an active member of an S Corporation with more than two percent of the membership interest (greater than two percent members) is essentially treated as self-employed and not as an employee.¹⁸¹ Like LLC members, greater than two percent members of S Corporations are not eligible to receive tax favoured fringe benefits from their transparent company employer.¹⁸² Instead, the provisions of

assessable income to the member, and an allowable deduction for the LLC: *IRC 1986* (US), s 707(c).

¹⁷⁵ *IRC 1986* (US), s 1402(a): provides that self-employment income includes the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which the individual is a member.

¹⁷⁶ Some commentators argue that allocations to LLC members as a 'limited partner' should not be subject to employment taxes. This has resulted in planning strategies, including the imposition of an additional LLC between the active member and the LLC conducting the business. The efficacy of these strategies is by no means certain as they have not been subjected to judicial scrutiny. *IRC 1986* (US), s 1402(a)(13). Howard Friedman, 'The Silent LLC Revolution - The Social Cost of Academic Neglect' (2004) 38(1) *Creighton Law Review*, 27.

¹⁷⁷ It was reported that a prior Vice Presidential candidate John Edwards (running partner with Al Gore) appreciated the difference between allocations and wages, prompting him to use an S Corporation rather than an entity subject to Sub-Chapter K for the conduct of his law business to minimise self employment taxes. [cited 8 March 2007]. Available from: <http://www.traderstatus.com/IRSaudits.htm>.

¹⁷⁸ Treasury Inspector General for Tax Administration, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, Reference No. 2005-30,080 (2005), 2.

¹⁷⁹ Internal Revenue Services (US), *IRS Updates Tax Gap Estimates*, IR 2006-28, (February 14 2006).

¹⁸⁰ Joint Committee on Taxation, above n 168, 31. For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

¹⁸¹ *IRC 1986* (US), s 1372. Section 1372 invokes section 318 allocation rules for application of the more than 2 percent rule.

¹⁸² McNulty, above n 84, 62. Such favourable fringe benefits would include excludable health and accident plans or policies: *IRC 1986* (US), ss 105, 106, group-term life insurance and employer-provided meals and lodging: *IRC 1986* (US), s 132. However, there are still some fringe benefits

such benefits would be treated as distributions by the transparent company and taxed as such.¹⁸³

It is unclear, in this respect, precisely why there is this discrepancy between employment taxes, on the one hand, and fringe benefits for United States' transparent companies on the other hand.¹⁸⁴ The discrepancy or mismatch appears to be a consequence of legislative oversight, rather than deliberate policy formation. The application of employment and fringe benefits taxes illustrates the tension between a full aggregate approach and an alternative approach comprising transparency with some 'entity acknowledgement'.¹⁸⁵

In contrast to the United States position with employment taxes, a self-employment status can be advantageous in the United Kingdom for LLPs compared to corporations in terms of the application of the National Insurance Contribution (NIC).¹⁸⁶ When the LLP form is utilised, an LLP member would be regarded as self-employed rather than as an employee, and thus subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately nine percent.¹⁸⁷ An LLP member would be subject to an overall

that can be provided by the S Corporation to an active member, and there have been some alterations to allow self employees to deduct certain expenses, such as private health insurance.

¹⁸³ *IRC 1986* (US), s 1402(a). Actual distributions would not be assessed to the extent of the membership cost basis. Any excess would normally be assessed as a capital gain.

¹⁸⁴ Note increasingly the difference between self-employed and employees has been decreasing, as now self-employed can deduct 100 percent of their health insurance, and some fringe benefits are available to them.

¹⁸⁵ It is argued that the inconsistent application of employment taxes between S Corporations and LLCs is not desirable. A simple way that this could be rectified is by treating all greater than two percent members of S Corporations as self-employed. Allocations to these members would then be subject to employment taxes like LLCs and this would in turn enhance tax neutrality. Also, as this approach employs a distinction already used for fringe benefits, then this should consequently reduce compliance costs. Alternatively, if a member is regarded as 'active' (pursuant to the passive loss rules) then he or she should be regarded as self-employed irrespective of which transparent company is utilised. This test would then eliminate passive investors from being regarded as self-employed, which, by the nature of their investment they are not. The proposed reforms before the Senate Committee do not recommend either of these alternatives. Instead they recommend an approach that will raise additional tax revenue by addressing 'professional' firms only. It is argued that this proposal is better understood in terms of being politically acceptable, rather than trying to improve tax neutrality. Joint Committee on Taxation, above n 170, 31 and 34.

¹⁸⁶ The NIC is a tax to pay most of the cost of retirement pensions, unemployment benefits and sickness benefits. It should be acknowledged that in the circumstance that the member was not engaged as an employee by the corporation, it is likely that a non-member would have to be employed with a resulting NIC obligation anyway. Also, a self-employed person will qualify to be relieved by pension contributions (subject to annual limits), whereas dividend income cannot be relieved in this way. Normally, an LLP member is not to be regarded for any purpose as employed by the LLP unless the member would be regarded as employed by a general partnership in like circumstances. *LLP Act 2000* (UK), s 4(4). If treated as employee, then the LLP member would be within the scope of the *Income Tax (Earnings and Pensions) Act 2003* (UK) and with the NIC consequences of employer/employee relationship. *PDC Copyright (South) v George* (Sp C 141), [1997] SSCD 326.

¹⁸⁷ Inland Revenue (UK), Limited Liability Partnerships, *Inland Revenue Tax Bulletin – Issue 50* (2000) [cited 20 September 2006]. Available from: <http://www.hmrc.gov.uk/bulletins/tb50.htm#2>: confirms members of LLP will be liable for Class 2, 3 and 4 NIC as appropriate. For self-employed persons they are initially subject to Class 2 NIC which is a flat £2.10 per week – although they can be exempted if their yearly profit is below £4,465 per year (2007 year). In addition to Class 2 NIC, self-employed persons can be subject to Class 4 NIC, which is 8 percent on profits from £5,035 to £33,450, and then 9 percent of profits in excess of £33,450. NIC would

NIC rate of nine percent on allocated income, compared with up to 23.8 percent for an employee-member of a corporation. Due to this disparity the LLP can be an attractive alternative to a corporation when the members are actively engaged in the business.¹⁸⁸ The impact of NIC was identified as part of the reason professional firms lobbied for the introduction of LLPs with general partnership tax treatment. This was despite the fact that the firms could have utilised a corporate form to obtain liability protection.¹⁸⁹

While New Zealand does not have an employment tax or payroll tax, the status of employment is important for fringe benefits tax purposes. Due to entity acknowledgement, an active member of a LAQC is treated as an employee and thus is able to access the concessional treatment of fringe benefits. If fringe benefits are provided to LAQC employee-members, the expenditure incurred in providing these benefits should be fully deductible for the LAQC.¹⁹⁰ It should be noted that the LAQC could be liable for FBT¹⁹¹ and this benefit would be non-assessable to the employee-member.¹⁹² Although, this treatment is consistent with other corporations in New Zealand, it is at odds with the benefits provided to members of a general partnership.¹⁹³ This is because general partnerships are not separate legal entities to their members, and therefore a member cannot be an employee of a partnership in which the member has an equity investment.¹⁹⁴ The consequence of this is that a benefit provided to a member of a general partnership is non-deductible — in terms of the general partnership and assessable to the member. This difference between LAQCs and general partnerships appears to result from an entity acknowledgement for LAQCs, rather than from the adoption of a full aggregate approach.¹⁹⁵ Unlike the S Corporation, the LAQC does not use a two percent membership test to provide greater tax neutrality between transparent companies and general partnerships.

apply to a non employee-member of an LLP as there is no requirement that the member carries on the business: *McDougall v Smith* 7 TC 134.

¹⁸⁸ Claire Crawford and Judith Freedman, Small Business Taxation. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century* (2008): “Another benefit of self-employment status is that tax deductions may be more accessible due to a less stringent deductibility test compared to employees. Employee’s test is ‘incurred wholly, exclusively and necessarily in the performance of the duties of employment’: *Income Tax (Earnings and Pensions) Act 2003* (UK), s 336. Self-employed test is ‘incurred wholly and exclusively for the purpose of trade: *Income Tax (Trading and Other Income) Act 2005* (UK), s 34.

¹⁸⁹ For a discussion about the drivers influencing the introduction of LLPs in the United Kingdom refer to: Freudenberg, above n 38.

¹⁹⁰ This is subject to the stipulation that they meet the normal deductibility criteria.

¹⁹¹ Normally when a fringe benefit is provided by a corporation, then the corporation pays 64 percent tax on specific benefits provided to employees. These benefits include the use of cars, low interest loans, contributions to insurance and superannuation. Inland Revenue (NZ), above n 69, 41.

¹⁹² Inland Revenue (NZ), above n 69, 41 .

¹⁹³ As well as benefits that sole proprietors might provide to the member.

¹⁹⁴ *Case S75 85 ATC 544*: holding that a partner salary was not deductible.

¹⁹⁵ Also, because members of a general partnership cannot be employees of the general partnership, so there can be no deduction normally for the salaries paid to them, seen as drawings: *Case F123* (1984) 6 NZTC 60, 157; and *Case L28* (1989) 11 NZTC 1,172. The exceptions to this are (a) when member’s salary is made under a written contract of service; and (b) when tax deduction allowed for pension is of a reasonable amount. Renting of property from general partnership member is deductible provided reasonable. Interest on capital contributions is not deductible, but on proper member-to-general partnership loans is deductible .

Therefore, in all the jurisdictions studied there are inconsistencies in the tax treatment of active members as either self-employed persons or employees. This appeared to be influenced by the extent of 'entity acknowledgement' with the transparent system. Status as either self-employed or employee could be beneficial or detrimental depending upon the jurisdiction and the applicable tax treatment. It is beyond the scope of this article to consider whether it is appropriate to tax self-employed persons differently to employees. However, it is contended that, in terms of transparent companies, there needs to be a consistent approach in terms of the categorisation of members (particularly when active in the business).

In the context of this discussion, it would be more theoretically consistent if active members of a transparent company are treated as self-employed. This is because tax transparency essentially is predicated on disregarding the legal form for taxation purposes and treating the economical activities of the underlying business as being those of the constituent members.¹⁹⁶ Such an approach reflects an 'aggregate approach' rather than 'entity acknowledgment'. It is argued that active members should be regarded as self-employed. Indeed there is merit for all members (regardless of the extent of their involvement) to be considered self-employed. However, this then means that for a tax transparent company in Australia, active members would not be able to access concessional tax fringe benefits.

For the reasons outlined in this article, it is argued that the introduction of a fully tax transparent company in Australia is unlikely to assist closely held businesses to address their financing issues. This is due to restrictions of membership numbers, assessment for unpaid allocations, the differential between the corporate and individual tax rate and the treatment of fringe benefits to active members. However, there are benefits in terms of capital gains, allocation of losses and access to tax preferences. It is due to these reasons, that if a transparency regime is going to assist Australian closely held businesses in terms of finance – that a partial loss transparent company is advocated.

VI PARTIAL LOSS TRANSPARENT COMPANY

The interaction between corporate and individual tax rates in Australia is of particular importance given the financing problem that can confront closely held businesses and their reliance on funding from members. For this reason, it may be preferable to have a partial loss transparent company, similar to New Zealand's LAQC.¹⁹⁷ In this way, when the Australian tax transparent company has income, profits would be initially assessed at the entity level at 30 percent, with franking credits being generated on the income tax paid. It is argued that such a partial loss transparent company may be a necessary compromise to striving for the economic ideal when taking into account complexity and financing.

¹⁹⁶ Head, above n 25, 22.

¹⁹⁷ In the New Zealand context it remains to be seen whether LAQCs remain as a popular taxing method due to the recent introduction of tax transparency applying to LLPs there. However, this the choice between the LAQC and LLPs in New Zealand may be influenced by the underlying governance rules which differ between the two forms.

Such a system would allow income to be accumulated at the entity level and to be available for further reinvestment into the business. However, accumulated profits would have to be allocated to members so to increase their membership cost basis, which would influence their ability to utilise any losses allocated by the partial loss transparent company.¹⁹⁸ Such a mechanism would be consistent with the policy recommended by Pizzacalla to improve the capital of small and medium enterprises.¹⁹⁹

It is argued that such a partial loss transparent company would provide greater incentive for Australian investors to adopt transparency. Later distributions to members would either be franked or unfranked. 'Distributions' would include profit distributions, loans to taxpayers and the transfer of assets from the transparent company to the member.²⁰⁰ If a franked distribution was received, it would be assessable to members, with members offsetting their tax liability with franking credits.²⁰¹ If a distribution were unfranked, it would be exempt income for the receiving members, thus allowing tax preferences to flow through to members. Such treatment would be advantageous, compared to that of members of a corporation, as most tax preferences are 'clawed back' on distribution.²⁰² Also such distributions would decrease a membership cost basis.²⁰³

When the Australian partial loss transparent company had losses these would be automatically allocated to members in accordance with their membership interest, and subject to a loss restriction rule based on the CFC hybrid rules (with amendments).²⁰⁴

¹⁹⁸ It is argued that retained profits should allow the greater utilisation of losses as these profits are at risk should the transparent company become insolvent.

¹⁹⁹ Mark Pizzacalla, 'Global SME tax policy conundrum' (2008) 23(1) *Australian Tax Forum* 40, 85.

²⁰⁰ The inclusion of member loans would negate the need for Division 7A to apply to transparent companies.

²⁰¹ Such distributions would decrease the membership cost basis.

²⁰² A possible exception to this is when the distribution is made as part of a liquidator's distribution: then there may be a flow-through of pre-CGT profits: *ITAA 1936* (Cth), s 47A.

²⁰³ However, there may be need to introduce a rule to prevent dividends being paid out of asset revaluation reserves when the underlying asset would, if disposed of, be subject to CGT. Otherwise the ability to pay dividends from asset revaluation reserves could be an artificial way to create tax preferences, and thereby exempt 'unfranked' dividends. For a discussion about asset revaluation reserve distributions see: Brett Freudenberg, 'The end of asset revaluation reserve distributions? An analysis of the Government's latest attack on discretionary trusts performing asset revaluation reserve distributions' 33(2) *Australian Tax Review* 150.

²⁰⁴ Freudenberg, above n 24. To reduce the tax arbitrage between the partial loss transparent company and members, allocated tax losses could be converted to a 'loss tax credit' calculated at the corporate tax rate. Such an allocated loss tax credit could be used by members to offset their tax payable, or be refunded if exceeding the member's tax liability. For example, a \$1000 worth of losses would be converted to a loss tax credit of \$300 and allocated to members to use as an offset. This mechanism would be mean that allocated losses would shelter income at the member level at the same rate as that applying to corporations, rather than the individual marginal tax rates of up to 45 percent. It is such an idea advocated by the Australian mining industry for a flow through share. Association of Mining and Exploration Companies, Australasian Institute of Mining and Metallurgy, Australian Securities Exchange, Australian Shareholders Association, The Chamber of Minerals and Energy of Western Australia, Minerals Council of Australia, Queensland Resources Council and South Australian Chamber of Minerals and Energy, "*Joint Industry Submission: To the Minister for Resources and Energy, The Hon. Martin Ferguson AM MP, - A proposal to introduce 'flow through shares' (FTS) in Australia.*" (5 November 2008), 12 – 15. Indeed, instead of introducing two discrete transparent regimes, one for closely held businesses and the other for

It is argued that a partial loss transparent company achieves a result similar to the Danish dual tax company system,²⁰⁵ which allows re-invested unincorporated business income to be taxed at the corporate rate, with only distributions taxed at the individual marginal tax rates.²⁰⁶ The tax advantage of allowing for a partial loss transparent company could be important in influencing the overall utilisation rates of such a transparent form.

However, unlike the LAQC it is argued, active members should be regarded as self-employed. This would mean that the receipt of benefits would be regarded as a distribution by the transparent company to the member and taxed accordingly.²⁰⁷ Note this would mean that such members could not access concessional FBT treatment. It is argued that a partial loss transparent company may have other benefits in terms of complexity and revenue collection.²⁰⁸

Another way that this proposal could assist closely held businesses with their financing is that while a conduit principle would not be directly evident,²⁰⁹ the treatment of unfranked dividends as exempt income would allow tax preferences to flow through to members.²¹⁰ While such a partial loss transparent company would not be able to access the 50 percent discount on capital gains provided to individuals, the corporate tax rate of 30 percent is comparable to the 50 percent of the highest marginal tax rate applying to individuals (plus Medicare levy).²¹¹

Of course disadvantages with this option need to be acknowledged. For example, there could be increased complexity due to measuring the membership

the mining industry, a partial loss transparent company could be a universal transparency regime in Australia.

²⁰⁵ Also known as the dual tax system.

²⁰⁶ Peter Sorensen, 'Recent Innovations in Nordic Tax Policy: From the Global Income Tax to the Dual Income Tax' in Sorensen, P (ed) *Tax Policy in the Nordic Countries* (1998); Steffen Ganghof, 'Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes' in FW Scharpf and V A Schmidt (eds) *Welfare and Work in the Open Economy* (2000), 619.

²⁰⁷ A similar consequence would follow in respect of superannuation contributions made on behalf of an active member.

²⁰⁸ Another benefit of the partial loss transparent company is that it has greater entity acknowledgement and thus if arguments about the adverse nature of full aggregation in respect of compliance costs are correct, then this should decrease compliance cost. This would mean that the membership interest is treated as a separate tax asset – rather than members having direct fractional interests in the underlying assets. Furthermore, a partial loss transparent company could assist in the collection of tax, as the tax paid initially by the business form acts as a form of withholding tax. Such transparency could also assist with problems about the interaction between the capital protection rules and unpaid allocations, as members are not assessed on retained profits. Also this option has the benefit that special tax rules would be drafted to provide for this partial loss transparent company rather than having an overlay of general partnership tax rules. Also, given the New Zealand experience it could be possible for existing corporations to transfer into the regime on the payment of corporate tax on any retained profit not covered by franking credits. Such a payment of tax would be necessary, as after entering into the regime the distribution of unfranked dividends would be exempt income for members.

²⁰⁹ That is, capital profits realised at the entity level would not retain their capital nature on distribution to members.

²¹⁰ For example, the amount of capital gain sheltered from tax due to indexation method would be non-assessable as exempt income on distribution to member if an unfranked dividend.

²¹¹ Assuming an individual is on the highest marginal tax rate, then the effective tax rate on a discounted capital gain is 23.25 percent.

cost basis (including altering it for retained profits within the entity).²¹² Furthermore, in New Zealand the possible repeal of the LAQC regime has been raised a number of times.²¹³ However, it is argued that this is due to inadequate loss restriction rules applying to LAQCs.²¹⁴ Given the loss restriction rules argued for this should not be the circumstance in Australia.²¹⁵

VII CONCLUSION

Through the analysis within this article it is questionable to what extent a transparent company as formulated in the ICAA proposal will assist Australian closely held businesses in addressing their financing problems. This article has demonstrated that transparency does not necessarily assist closely held businesses in addressing their financing problems. If the eligibility requirements for transparency are too strict, this may reduce the ability of the business to raise equity from alternative sources. Additionally, while there may be tax savings achieved through transparency, this is not always the case when compared to corporations. This will depend upon many factors, such as the corporate tax rate, the individual tax rate and the treatment of capital receipts. However, access to tax losses, tax preferences and the one layer of taxation on capital gains can be advantageous. It was demonstrated that transparency could assist in reducing the tax preference of debt compared to equity funding. An important consideration to determine the taxation burden included the treatment of members as either employees or self-employed.

This led to a recommendation for eligibility for transparency depending upon three factors: membership interest in the business form not being publicly traded, a member/manager election and jurisdictional symmetric treatment; but with the possibility of one class of membership interest. Also, it was argued that active members of a transparent company should be regarded as self-employed rather than as employees.

While the suggestion that a fully transparent company will be beneficial for closely held businesses in Australia is attractive, given the existing Australian tax system and the experience overseas this may not be the case in terms of addressing the finance problem. It may be the circumstances that given Australia's existing business forms and imputation system for corporations that a partial loss transparent company, rather than a fully transparent company, is the preferable option.

²¹² Such a proposal in the United States was considered too complex, and instead a basic 15 percent concessional rate was introduced.

²¹³ For the most recent consideration see: Michael Cullen (Minister of Finance) and Peter Dunne (Minister of Revenue), *General and limited partnerships — proposed tax changes: A government discussion document* (2006).

²¹⁴ Brett Freudenberg, 'The Troubled Teen Years: Is the repeal of New Zealand's LAQC regime required?' (2008) 14(1) *NZJTL* 67.

²¹⁵ Also, to improve the uptake of such a transparent entity, serious consideration should be given of applying capital gains and stamp duty relief for existing business forms to convert to this model, particularly discretionary trusts. There could be a transition period of five years to allow for this conversion.

INDIRECT TAXATION OF WINE: AN INTERNATIONAL COMPARISON

PAUL KENNY*

The highly competitive international wine market imposes serious pressure on the viability of small wine producers as well as emerging wine nations. In this light this paper will examine the indirect taxes levied on wine manufactured in new world wine nations, Australia and New Zealand, and an old world wine nation, France. These indirect taxes include value added taxes, excises and customs duties. This paper will focus on wine produced for domestic consumption and export, as well as imported wine. The aim of comparing these indirect taxes is to help inform the debate about the indirect taxation of wine. This is highly relevant given the current review of Australia's taxation system.

I INTRODUCTION

Australia, New Zealand and France employ different indirect tax systems for wine¹ that are a result of numerous factors such as economic, social, cultural and historical. This paper seeks to compare the indirect tax laws on wine of the 'Old World' wine country (France) and the two 'New World' (Australia and New Zealand) wine countries. The aim of comparing these indirect taxes is to help inform the debate about the indirect taxation of wine. This is highly relevant given the upcoming review of Australia's tax system.²

First, this article examines the rationale for specific wine taxation. Secondly, the article provides an overview of the goods and services tax (also known as the value added tax), sales tax (also known as the Wine Equalisation Tax), customs and excise duties that apply to wine in Australia, New Zealand and France. Thirdly, the article examines these wine tax policies based on the generally accepted tax policy criteria of fiscal adequacy, economic efficiency, equity and simplicity. The article finds that there is no strong case for a specific tax on wine on tax policy grounds.

II THE RATIONALE FOR WINE TAXATION

For economies that employ a broad consumption goods and services tax (also known as the value added tax) such as Australia, New Zealand and France,

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¹ This article focuses on unfortified alcoholic grape wine.

² The taxation review is to provide a final report by the end of 2009 into the Australian Government and State taxes (except the rate and base of GST) as well as the interaction with the transfer system <taxreview.treasury.gov.au/>.

wine is included as part of the consumption tax base and taxed along with most other types of goods and services in order to raise government revenue.³

Many countries impose additional specific taxes on wine. The rationale for this further level of taxation is twofold. Specific tax is based on revenue raising grounds⁴ or on the basis that it corrects for externalities.⁵ On revenue raising grounds, it is argued that a wine tax minimises consumption distortions. Since wine has highly inelastic demand schedule consumption is minimally affected by a small increase in price. Additionally, it is argued that a wine tax is justified on the basis that it corrects external costs which are not included in the market price of the goods. For alcohol these are the health costs from alcohol related road accidents and alcohol abuse. As discussed below, there are weaknesses in both of these arguments, and from a tax policy perspective other considerations such as economic efficiency, equity and simplicity should be taken into account.

III INTERNATIONAL COMPARISONS OF INDIRECT TAXES ON WINE

This paper examines the tax base and rates for the following types of indirect taxes on wine in Australia, New Zealand and France.

- Goods and Services tax / Value Added Tax
- Sales tax
- Excise tax
- Customs duty

A number of minor levies and other imposts also apply to wine,⁶ however, these charges are excluded from this analysis given their small quantum.

³ P Costello, (Treasurer) House of Representatives, *A New Tax System (Goods and Services Tax) Bill 1998, Second Reading Speech*, stated on the introduction of Australia's goods and services tax (GST): ‘

From 1 July 2000, the Commonwealth will provide States with a secure and growing source of revenue by giving them the revenue from the GST...

⁴ For example, in Australia, on 18 August 1993 the Commonwealth Government increased the tax on wine from the general wholesales tax rate (WST) of 20% to 31%. The rationale for this increase is clear given the name of the amending legislation: *Sales Tax (General) (Deficit Reduction) Act 1993*; *Sales Tax (General) (Wine - Deficit Reduction) Act 1993*. Also, on 6 August 1997 when the WST rate for wine 26% to 41% the Government provided revenue raising as its rationale. The Explanatory Memorandum to the *Sales Tax Assessment Amendment Act 1997* stated:

In order to protect the future revenue of States and Territories, and in response to the unanimous request of the States and Territories, it is proposed that Commonwealth excises on petroleum and tobacco and sales tax on alcoholic beverages be increased to collect the revenue which would be lost by the States and Territories. [as a result of constitutional invalidity of the state franchise fee on alcohol].

⁵ ACIL Consultants, 'Pathways to Profitability' (2002) report commissioned by the Commonwealth Department of Agriculture, Fisheries and Forestry, 97-98; W J McCarten and J Stotsky, 'Excise Taxes' in *Tax Policy Handbook* (1995), (P Shome ed) International Monetary Fund, Washington.

⁶ For example, in New Zealand, the Alcohol Advisory Council imposes a levy on all alcoholic beverages. The New Zealand Ministry of Health sets the rate each year in March and takes effect from 1 June. The current ALAC levy rates on unfortified wine is (NZ\$) 4.93 cents per litre and for fortified wine, (NZ\$) 8.04 cents per litre. Whilst, Australia levies a wine export charge on exporters to provide funds for the Australian Wine and Brandy Corporation to undertake international promotional work and increase wine demand. Also, a Grape Research Levy and Wine Grapes Levy are imposed to assist the wine industry.

IV AUSTRALIA

A Overview

Australia has only a relatively recent history of high levels of indirect taxation of wine. This is evident from the following summary of the history of wine taxation:⁷

1930: Wholesale Sales Tax (WST) of 2.5 percent introduced, removed one year later. 1970: 50c per gallon wine excise introduced, halved one year later and completely removed after a further 6 months.

Prior to August 1984: various franchise fees at state level.

August 1984: 10 percent WST imposed in Commonwealth budget. [Wine was subject to the general WSR rate]

August 1986: WST increased to 20 percent. [With the increase in the general WST rate]

August 1993: Commonwealth increased the WST to 31 percent with the intention of it increasing further to 32% in July 1985. This was strongly opposed by the wine industry and Opposition. In October 1993, the government and the industry, The Winemakers' Federation of Australia (WFA) reached agreement that the WST would decrease to 22% then increase to 24% and 26% in annual increments...

September 1995: report of wine inquiry released...

August 1997: High Court struck down the constitutional validity of the state franchise fee. To minimise the revenue losses to the states the Commonwealth agreed to increase the WST to 41 percent with the additional 15 percent was rebated to state governments an *ad valorem* partly to wineries in respect of their cellar door sales.

July 2000: GST introduced (10 percent) Also Wine Equalisation Tax (WET) at 29 percent of the wholesale price, along with rebate arrangements.

Surprisingly, during the time of the introduction of the Wholesale Sales Tax (WST) on wine (at 10-20 percent) the Commonwealth introduced a Vine Pull Scheme between 1985-88 to offset the grape glut.⁸ Notwithstanding the further increases of indirect taxes on Australian wine, from 1990 to 2005 Australia became a net exporter of wine and exports increased from 380 thousands of hectolitres⁹ (mhl) to 7,019 mhl, more than a 17 times increase.¹⁰ Outside of Europe, Australia is the largest exporter of wine but only accounts for 5 percent of

⁷ Above n 5, 93.

⁸ Rural and Regional Affairs and Transport References Committee, Australian Senate Parliament House 'Questions Taken On Notice at Public Hearing into the Operation of the Wine-making Industry', Wednesday, 10 August 2005
http://www.aph.gov.au/Senate/committee/rrat_ctte/completed_inquiries/2004-07/wine/submissions/daffresponse.pdf.

⁹ A hectolitre equals 100 litres.

¹⁰ Australian Wine and Brandy Corporation, 'Wine in Europe'
<http://www.wineaustralia.com/australia/Default.aspx?tabid=873Ibid>.

world wine production.¹¹ This is an impressive result given the falling worldwide consumption of wine.¹²

The Australian wine industry makes a significant contribution to the economy employing 27,959 people in 2006.¹³ The complexity of manufacture and marketing mean that it is a high value added process. It is also a regional business and drives regional communities. In 2008 there were 2,299 wineries operating in Australia and 89 defined wine regions.¹⁴ Further, the wine industry makes a significant impact on the tourism industry.¹⁵

B *The Good and Services Tax*

The Goods and Services Tax (GST)¹⁶ is a broad based consumption tax that is levied on the consumption of goods and services. GST or value added tax (VAT) vary all over the world but share the principle of taxing a broad base of goods and services, and they also permit businesses to offset the GST paid on their inputs against their GST liability.¹⁷ Thus the GST is only collected on the value added by each business in the production and distribution chain. The GST is ultimately paid the final consumer. Certain goods and services are excluded from the tax base by providing a GST free rate¹⁸ or by being an input taxed supply).¹⁹ Under a GST free supply GST is not paid on the sale of the good or service and the supplier of the good or service is entitled to a refund of the GST paid on their inputs.

For input taxed supplies, GST is not paid on the sale of the good or service and the supplier is not entitled to a refund of the GST paid on their inputs.²⁰ The input taxed method is used where it is technically difficult to impose GST but it is not appropriate to allow the sale to be GST free. Thus input taxation results on a reduced tax rate to final consumers as the supplier does not add GST. For business to business suppliers it increases the effective tax rate since business purchasers cannot offset the GST paid on the suppliers inputs from their GST liability.

The standard GST rate is 10 percent²¹ and this is applied to domestically produced and consumed wine. For imported wine, GST is imposed on 10 percent of the value of the importation.²² The importation value is the sum of the customs value, additional insurance and freight costs to place of consignment, customs duty or wine tax.²³ Wine exports are GST free.²⁴

¹¹ Above n 10.

¹² See Appendix 1, Table A2.

¹³ Winemakers' Federation of Australia, 'Submission to Australia's future tax system review' (2008), 10.

¹⁴ Above n 13, 11, 12.

¹⁵ Above n 13, Tourism Australia found that wine tourism grew stronger than the average annual growth for any other visitor types.

¹⁶ *A New Tax System (Goods and Services Tax) Act 1999 (Cth)* (GSTA 1999).

¹⁷ Eg see GSTA 1999 Div 7, s 17-5.

¹⁸ GSTA 1999 Div 38.

¹⁹ GSTA 1999 Div 40.

²⁰ GSTA 1999 s 9-30(2).

²¹ *A New Tax System (Goods and Services Tax Imposition- General) Act 1999 (Cth)* s 4.

²² GSTA 1999 s 13-20.

²³ Above n 22.

²⁴ Subject to meeting the requirements of subdiv 38-E GSTA 1999.

C Wine Equalisation Tax

Sales taxes are levied on the general consumption of goods and services but unlike a GST, sales taxes are only levied at one stage of the production or distribution process, for example at the manufacturing, wholesale or retail stage.²⁵ France and New Zealand do not impose sales tax on wine.

Australia imposes a sales tax on wine, known as the Wine Equalisation Tax (WET).²⁶ The WET commenced on 1 July 2000 and was designed to replace the former wholesale sales tax²⁷ on wine.²⁸ Sales Tax was abolished on 30 June 2000 with the introduction of the GST and the WET.

WET imposes a wine tax on the taxable value of assessable dealings²⁹ with wine³⁰ in Australia.³¹ The tax is applied to both Australian produced wine and imported wine. The primary types of assessable dealings are: wholesale sales;³² retail sales;³³ application of wine for own use³⁴ and certain importations.³⁵ Some assessable dealings such as exports are exempt.³⁶

The WET is payable by wine manufacturers, wine wholesalers and wine importers. Retailers of wine pay WET in the sense that their payments to suppliers for wine includes a mark up for WET paid. In this way WET is passed on in the price of the wine to the end consumer. WET is calculated at the rate of 29 percent³⁷ of the taxable value of assessable dealings with wine in Australia.³⁸

²⁵ R Warburton and P Hendy, 'International Comparisons of Australia's Taxes', (2006) *Commonwealth of Australia*, 251.

²⁶ *A New Tax System (Wine Equalisation Tax) Act 1999* (WETA 1999).

²⁷ Former the *Sales Tax Assessment Act 1992 (Cth)* (STAA); *Sales Tax (Exemptions and Classifications) Act 1992*; *Sales Tax Imposition (Excise) Act 1992 (Cth)*, *Sales Tax Imposition (Customs) Act 1992*, the *Sales Tax Imposition (General) Act 1992* and the *Sales Tax Imposition (In Situ Pools) Act 1992*.

²⁸ Prior to the WET the last wholesale sale of wine was subject to sales tax at the rate of 41%. Given the GST rate of only 10% wine prices would have dropped severely.

²⁹ WETA 1999 s 5-5. Assessable dealings include selling wine, using wine, or making a local entry of imported wine at the customs barrier.

³⁰ WETA 1999 ss 31-1, 31-2, 31-3, 31-4, 31-5, 31-6 and 31-7. Wine is defined to include alcoholic products that contain more than 1.15% by volume of ethyl alcohol that are grape wine; grape wine products (such as marsala, vermouth, wine cocktails and creams); fruit wines or vegetable wines; and cider, perry, mead and sake.

³¹ WETA 1999 s 5-5.

³² WETA 1999 s 33-1: 'A wholesale sale means a sale to an entity that purchases for the purpose of resale, but does not include a sale of wine from stock in a retail store (or retail section of a store) to make up for a temporary shortage of stock of the purchaser, if the wine is of a kind that: (a) is usually manufactured by the purchaser; or (b) is usually purchased by the purchaser for resale.' The most common assessable dealing involves the sale of wine by a winery to a retailer, or a sale of wine by a distributor to a retailer.

³³ WETA 1999 s 33-1. 'A retail sale is a sale that is not a wholesale sale.' This commonly is a sale made to a person who does not purchase the wine for the purpose of resale. For example, a sale at the cellar door of a winery.

³⁴ Australian Taxation Office, Wine Equalisation Tax Ruling WETR 2004/1 para 33. This usually involves: 'wine used for cellar door tastings; wine used for tastings at exhibitions; wine used for wine shows; wine used for promotions; wine donated to charity; wine given to retailers, restaurants and so on, as samples; wine given to staff; and wine taken for personal consumption.'

³⁵ Such as the entry of imported wine for home consumption.

³⁶ WETA 1999 s 7-5.

³⁷ *A New Tax System (Wine Equalisation Tax Imposition – General) Act 1999*, *A New Tax System (Wine Equalisation Tax Imposition – Customs) Act 1999*, *A New Tax System (Wine Equalisation Tax Imposition – Excise) Act 1999*.

The WET is calculated on the selling price of the wine excluding wine tax and GST. Where wine is not the subject of a wholesale sale, ie where it is sold at cellar door or used for tastings or promotional activities the WET provides for calculation of alternative values for the tax payable.³⁹

The WET forms part of the GST tax base and GST is payable on the value of the wine including any WET component. For imports, an assessable dealing with wine is taxable when it enters Australia. The taxable value is equal to the GST importation value of the wine.⁴⁰ The GST importation value is the customs value plus the costs of transport, insurance and duty.⁴¹

The following diagram provides an overview of the WET:⁴²

³⁸ WETA 1999 s 5-5.

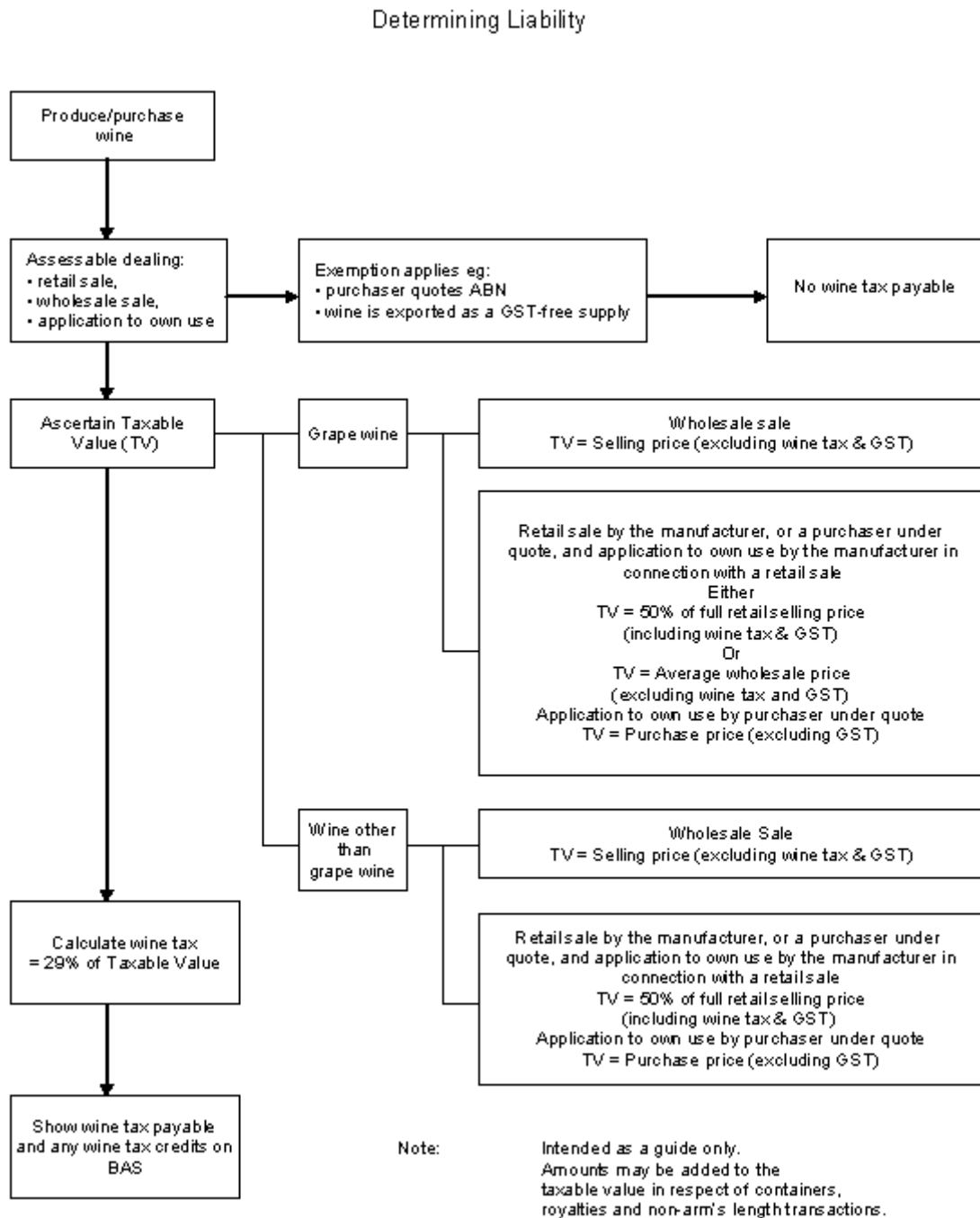
³⁹ WETA 1999 Div 9.

⁴⁰ Assessable Dealing AD10 in the Assessable Dealings Table in section 5-5 WETA 1999.

⁴¹ GST Act 1999 ss 13-20, 33-1, 195-1.

⁴² Australian Taxation Office, Wine Equalisation Tax Ruling, WETR 2004/1, Wine equalisation tax: the operation of the wine equalisation tax system, Appendix C.

Figure 1: How the WET Works



The WET⁴³ and the GST⁴⁴ provide a concessional cash accounting rule for business with annual turnovers of less than \$2 million. This means that eligible small wineries do not pay WET or GST until they actually sell the wine. It is argued that this fails to take into account the special rules that apply to the wine industry where the WET and GST have a far greater impact on cash flow than for

⁴³ WETA 1999 s 21-10.

⁴⁴ GSTA 1999 s 29-40.

other types of businesses.⁴⁵ The Winemakers' Federation of Australia (WFA) provides the following example:⁴⁶

... for a winery that turns over \$4 million the adverse cash flow impact of remitting WET and GST in advance of receiving sales is estimated at approximately \$200,000. That is \$200,000 of the winery's working capital is tied up in GST and WET prepayments.

D *WET Producer rebates*

A rebate of WET applies for producers of rebatable wine that are registered or required to be registered for GST in Australia.⁴⁷ From 1 July 2006, the maximum amount of rebate an Australian producer, or group of associated producers,⁴⁸ can claim in a full financial year is A\$500,000.⁴⁹ This is equivalent to about A\$1.7 million wholesale value of eligible sales and applications to own use per annum. Given this highly favourable tax treatment there are 2,072 small wineries (or 96 percent of wine producers) that do not have to pay WET.⁵⁰

E *Excise Duties*

Excise duties are levied on the production of certain goods.⁵¹ Excise duties are generally assessed according to the quantity, weight, volume or strength of a product.⁵² In respect of alcoholic beverages excise duties are generally applied according to the alcoholic content of the product or on the value of the product or a combination of these.⁵³ Generally excise duties must be paid on wine before it can be sold for consumption. Additionally, excise duties form part of the GST tax base. That is, GST is calculated on the value of the good including its excise duties. Excise duty is imposed by the *Excise Tariff Act 1921 (Cth)*. However, wine is not an excisable good since the WET applies to wine.

F *Customs Duties*

Customs duty is usually levied on certain imported goods.⁵⁴ These duties are based on the value of the imported good or on a quantitative / volumetric basis.⁵⁵ Like excise duties, customs duties must normally be paid on wine before it can be sold for consumption and form part of the GST tax base. GST is calculated on the value of the good including its customs duties.

⁴⁵ Above n 13, 21.

⁴⁶ Above n 13.

⁴⁷ WETA 1999 s 19-5(1).

⁴⁸ WETA 1999 s 19-20,

⁴⁹ WEA 1999 s 19-15. Previously, from 1 October 2004 to 30 June 2006, the maximum amount of rebate was \$290,000, ie exempting \$1 million (wholesale value) of sales per annum.

⁵⁰ Above n 13, 20.

⁵¹ Above n 25, 256.

⁵² Above n 25, 251.

⁵³ Above n 25.

⁵⁴ Above n 25, 255.

⁵⁵ Above n 25.

Customs duty is imposed by the *Customs Tariff Act 1995(Cth)* on imported goods either at the time of importation or, if the goods have been stored in a Customs-licensed bonded warehouse, at the time of their release from bond. Customs duties in Australia are levied on the value of imported wine (except New Zealand wine) and this is levied at the general rate of five percent.⁵⁶ Under the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) any product that has 50 percent or more New Zealand content may enter Australia duty free.

V NEW ZEALAND

A Overview

In the 1970s the New Zealand government used indirect taxation to support the local wine industry and to earn foreign exchange.⁵⁷ It developed a complex series of tariffs and tariff quotas. The following table sets out the changes in tariffs and wine imports from 1986 to 1998:⁵⁸

Table 1: Changes in New Zealand Tariffs and Wine Imports 1986-98

Date (as 1 July of)	Specific tariff (cents/ litre)	Ad valorem tariff (%)	Imports in million litres	Imports as % of total consumption
1986	68	20	2,792	6.5
1987	51	21.25	3,732	9.2
1988	34	22.5	4,375	10.8
1989	17	23.75	6,798	13.6
1990		25	7,988	13.8
1991		22	11,397	20.4
1992		19.5	8,418	19.6
1993		19	19,694	45.2
1994		17	32,695	49.6
1995		15	25,515	34.4
1996		13	21,318	31.5
1997		11	22,409	40.6
1998		9	28,231	39.3

As Table 1 shows, these tax policies meant that the importation of cheap wine were prohibitive in 1986.⁵⁹ At that time non-premium wine was greatly in demand in New Zealand and cheap wines dominated the market.⁶⁰ As a consequence domestic production of cheap varieties increased but this resulted in grape production exceeding demand.⁶¹ To restructure the industry away from

⁵⁶ *Customs Tariff Act 1995 (Cth)*.

⁵⁷ M Mikic, 'The impact of liberalisation: communicating with APEC communities, Wine industry in New Zealand', Australian APEC Study Centre Monash University, November 1998.

⁵⁸ Above n 57, 10. Source New Zealand Tariff Schedule, Statistics New Zealand.

⁵⁹ Above n 57.

⁶⁰ Above n 57.

⁶¹ Above n 57.

cheap wine production the NZ government in 1985 established the Grapevine Extraction Scheme to subsidise growers to remove vines.⁶² Further, as evident in the table, from 1987 the NZ government greatly reduced tariffs on wine. The special tariff was replaced with an ad valorem tax at 25 percent in 1990. The ad valorem tax was then phased down to 5 percent in 2000.⁶³ All tariff quotas were removed.⁶⁴ As noted above, a free trade agreement was established with Australia so all goods could enter New Zealand duty free.⁶⁵ As seen in the above table, wine imports grew as a result of the removal of tariffs. This has also resulted in a great increase in exports as domestic producers focused on premium wines.⁶⁶

An APEC study concluded that these policy changes meant that New Zealand became an export orientated industry rather than an import substituting industry.⁶⁷ The APEC study also found that New Zealand consumers benefited by the improved quality wine, reduction in price (per same quality), increase in wine varieties, access to more wine imports and their ability to substitute other alcoholic drinks for wine.⁶⁸

The New Zealand wine industry also makes a significant contribution to the economy being its 12th largest exporter.⁶⁹ It is also a regional business and drives regional communities. In 2006 there were 530 wineries operating in 11 defined wine regions.⁷⁰

B *The Good and Services Tax*

New Zealand's *Good and Services Tax Act 1985* (GSTA 1985 (NZ)) provides a broadly based value added consumption tax. The GST is imposed a standard GST rate of 12.5 percent⁷¹ and this is uniformly applied to most goods and services. The Organisation for Economic Co-operation and Development (OECD) considers the New Zealand GST to be one of the world's most effective value added taxes given its broad base and singular low tax rate.⁷² The GST applies to all domestically consumed wine. For imported wine GST is payable on the sum of the Customs value of the goods, any import duty, anti-dumping and countervailing duties, Alcoholic and Liquor Advisory Council (ALAC) levies payable, and the freight and insurance costs incurred in transporting the goods to New Zealand.⁷³ Wine exports are zero rated (ie GST free).⁷⁴

⁶² Above n 57. By 1990 1,517 hectares were pulled out.

⁶³ Above n 57.

⁶⁴ Above n 57.

⁶⁵ Above n 57.

⁶⁶ Above n 57; See Appendix 1.

⁶⁷ Above n 57, 11-12.

⁶⁸ Above n 57, 12.

⁶⁹ New Zealand Wine, *Annual Report 2007*, <http://www.nzwine.com/reports/>.

⁷⁰ Investment New Zealand, 'New Zealand Wine Industry', 2007, http://www.investmentnz.govt.nz/common/files/NZTE%20Wine%20Brochure_Low%20Res%20Apr07.pdf.

⁷¹ GSTA 1985 (NZ) s 8(1).

⁷² OECD 2000, 'OECD Surveys', (November 2000), 109, Figure 32.

⁷³ New Zealand Customs Service, 'Duties and Levies'

<http://www.customs.govt.nz/importers/Commercial+Importers/Duties+and+Levies.htm#paraTitle01>.

⁷⁴ Subject to satisfying the requirements of s 11 GSTA (NZ) 1985.

C *Wine Equalisation Tax*

Whilst New Zealand does not impose a WET, from 1 July 2005 the Australian WET producer rebate was extended to eligible New Zealand wine producers that have their wine exported to Australia.⁷⁵ The maximum amount of rebate a New Zealand producer, or group of associated producers, can claim in a full financial year is the same as Australian producers, that is A\$500,000.⁷⁶ 'Old World' countries such as France (or any other countries), though, cannot access the WET producer rebate.

D *Excise Duties*

All beverages containing alcohol, whether local or imported, are subject to excise duty or excise equivalent tax.⁷⁷ Currently, in December 2008, for unfortified wine the excise is NZ\$2.2592 per litre of the total beverage volume.⁷⁸ Every six months the excise is increased in line with consumer price movements.

E *Customs Duties*

Imported wines, except of Australian origin,⁷⁹ are subject to an additional seven percent ad valorem tax⁸⁰ on the customs value of the wine.⁸¹ The customs value is generally the transaction value, the price paid or payable for the imported goods.⁸² Overseas freight and insurance charges are deducted if these charges are included in the transaction value.⁸³

VI FRANCE'S INDIRECT TAXES

A *Overview*

In France domestically produced wine is subject to the standard rate of VAT and a small excise. Over the last 25 years at least, France has imposed relatively low levels of specific taxes on wine. The excise rates for still and sparkling wine have not changed since 1982 and for sweet wine it has not changed since 1993.⁸⁴

⁷⁵ WETA 1999 s 19-5(2). New Zealand wine producers may apply to the Australian Commissioner of Taxation to become approved New Zealand participants.

⁷⁶ WETA 1999 s 19-15.

⁷⁷ *Customs & Excise Act 1996* (NZ), Third Schedule.

⁷⁸ Above n 77.

⁷⁹ Under the Australia-New Zealand free trade agreement any product that has 50 percent or more Australian content may enter New Zealand duty free.

⁸⁰ Australian Wine and Brandy Corporation, *Export Market Guide- New Zealand*, (2008), 13.

⁸¹ *Customs & Excise Act 1996* (NZ), Third Schedule.

⁸² New Zealand Customs Service, 'Valuation of Imported Goods' <http://www.customs.govt.nz/importers/Commercial+Importers/Valuation.htm>.

⁸³ Above n 82.

⁸⁴ Direction Generale des Douanes et Droits Indirects, 'Tux d'accises en France et annee de la derniere evolution' 18 September 2008, (Table of French customs and excise duties on wine).

B *The Value Added Tax*

France imposes a broadly based VAT on consumption. The standard VAT rate is 19.6 percent and this applies to most goods and services, including wine.⁸⁵ All wine exports are GST free.

C *Excise Duties*

In accordance with the European Union (EU), the French excise duty is levied on still wine and sparkling wine by reference to the number of hectolitres of finished product.⁸⁶ The EU provides for a zero minimum excise per hectolitre for wine.⁸⁷ In France the excise rates for unfortified wine vary and they are assessed on the quantity and type of wine as follows:⁸⁸

Table 2: Excise duty on Wine in France

Type of wine	Euros per hectolitre
Still wine	3.40 € / hl
Sparkling wine	8.40 € / hl
Sweet wine	54 € / hl

This excise is very low, for example, for still wine this works out to €0.026 (or 2.6 cents) per 750 millilitre (ml) bottle.

D *Customs Duties*

As part of the harmonised trade system of the EU the Common Customs Tariff is applied to goods from non-EU countries.⁸⁹ Thus, French imports of wine from non-EU countries are subject to EU customs duties which vary depending on the percentage of alcohol contained in the wine and the type of container.⁹⁰ These customs duties must be paid on most products before they can access the EU.⁹¹ The following EU customs duties apply to wine:⁹²

⁸⁵ European Commission, 'Taxes in Europe electronic database' (2008) http://ec.europa.eu/taxation_customs/taxinv/getcontents.do?mode=normal&kw1=checked&kw2=-&kw3=-&coll=VERITY_FR++VAT.

⁸⁶ European Union, 'Council Directive 92/83/EEC of 19 October 1992 on the harmonisation of the structures of excise duties on alcohol and alcoholic beverages' <http://europa.eu/scadplus/leg/en/lvb/l31023.htm>. A hectolitre equals 100 litres.

⁸⁷ European Union, 'Council Directive 92/84/EEC of 19 October 1992 on approximation of the rates of excise duty on alcohol and alcoholic beverages' <http://europa.eu/scadplus/leg/en/lvb/l31024.htm>.

⁸⁸ Direction Generale des Douanes et Droits Indirects, 'Tux d'accises en France et annee de la derniere evolution' 18 September 2008, (Table of French customs and excise duties on wine).

⁸⁹ AWBC *Export Market Guide- European Union* above n 80, 14.

⁹⁰ Above n 89.

⁹¹ Above n 89, 9. The EU Commission's main regulations in respect of wine are Commission Regulation No 1493/199, 883/2001 and 753/2002. Australia also has a bilateral wine agreement with the EU

⁹² Above n 89. Total dry extract may affect tariff classification. When liqueur wines contain excessive dry extract (excessive means >90g/l at 13% vol) they are reclassified in the next fiscal

Table 3: Customs Duty on Imported Wine into the EU

	Euro/hectolitres for wine in containers of 2 litres or less	Euro/hectolitres for wine in containers of more than 2 litres
Sparkling wine (any strength) exceeding 1.5 bar at 20 degrees Celsius	32	32
Actual alcoholic strength at 20 degrees Celsius (% volume)		
• Not exceeding 13%	13.7	9.9
• Exceeding 13%, but not 15%	15.4	12.1
• Exceeding 15%, but not 18%	18.6	15.4
• Exceeding 18%, but not 22%	15.8	13.1
Aromatised Wine (Vermouth)		
• Not exceeding 18%	10.9	9
• Exceeding 18%	0.9 Euro per % vol/hl + flat surcharge of 6.4 Euro/hl	

The level of customs duty is quite modest. For example, for still wine above 13 percent and below 15 percent of alcoholic strength, this works out to €0.116 (or 11.6 cents) per 750 ml bottle.

VII ANALYSIS

The following tax policy analysis of specific wine taxation is based on the generally accepted tax policy criteria of fiscal adequacy, economic efficiency, equity and simplicity.⁹³ Given that Australia, New Zealand and France all apply a GST / VAT to wine at their respective standard tax rates, these tax policies are considered to be soundly based and not in need of any detailed analysis. Whilst a comparison of customs duties is dealt with separately below, it is outside the scope of this paper to undertake any trade policy analysis.

category and must pay the appropriate customs duty. The minimum alcoholic strength of “liqueur” wines is 15% and the maximum 22%.

⁹³ Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable, Report* July 1999 (1999) Australian Government Publishing Service, Canberra, 9,13; J Waincymer, *Australian Income Tax Principles and Policy*, (2nd ed, 1993) 26; J Alm, ‘What is an “Optimal” Tax?’ (1996) XLIX *National Tax Journal* 117, 117. Alm stated ‘A central issue in public economics is the appropriate design of a tax system. Such a system is usually viewed as balancing the various desirable attributes of taxation: taxes must be raised (revenue-yield) in a way that treats individuals fairly (equity), that minimizes interference in economic decisions (efficiency), and that does not impose undue costs on taxpayers or tax administrators (simplicity)’.

A *Fiscal Adequacy*

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

As discussed above, tax revenue provides a primary rationale for wine taxation. In 2006-07 Australia's WET produced A\$651 million of revenue.⁹⁴ This only represents 0.2 percent of total tax revenue of Commonwealth government tax revenue.⁹⁵ In France, the tax revenue from the excise tax on wine amounted to a mere €\$138.3 million in 2007.⁹⁶ In relation to total government revenue these taxes are miniscule.

Further, in a VAT or GST environment the case for specific excise taxes or wine taxes is greatly weakened. The rationale for a VAT or GST is to provide a broad tax base at a single rate to enable revenue to be raised at relatively low rates independent on consumption choices.⁹⁷ Thus, another level of indirect taxation on selected good and services undermines the policy objectives of a GST / VAT.

As noted above, it is argued that wine has a highly inelastic demand thus a wine tax minimises consumption distortions. The New Zealand Tax Review 2001 (NZ Review), though, found that the demand for wine is often more elastic than the demand for petrol, tobacco and beer.⁹⁸ The NZ Review calculated that the excises have high deadweight costs (losses in consumption efficiency) per dollar of additional tax revenue raised, relative to broadly based forms of taxation.⁹⁹

B *Economic Efficiency*

Given the long term decline in wine production and consumption¹⁰⁰ wine producers face a shrinking market pool. Further, changing consumption patterns towards premium wines presents new challenges for wine producers.¹⁰¹ Therefore, there is an increasing need for a competitive indirect tax system that will allow the wine industry to efficiently use its resources and compete effectively.

⁹⁴ Australian Treasury, *Architecture of Australia's Tax and Transfer*, (2008) Table 2.1 System http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/report/section_2-03.htm.

⁹⁵ Australian Treasury, *Architecture of Australia's Tax and Transfer*, (2008), http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_1-01.htm, Total tax revenue in 2007/08 was \$262.5 billion.

⁹⁶ Direction Generale des Douanes et Droits Indirects, 'Tux d'accises en France et annee de la derniere evolution' (18 September 2008), (Table of French customs and excise duties on wine).

⁹⁷ R McLeod, D Patterson, S Jones, S Chatterjee and E Sieper, *Tax Review 2001 – Final Report* (2001) Wellington, v.

⁹⁸ R McLeod, D Patterson, S Jones, S Chatterjee and E Sieper, *Tax Review 2001 – Issues Paper* (2001) Wellington, 28.

⁹⁹ Above n 98.

¹⁰⁰ See Tables A1 and A2 in Appendix 1.

¹⁰¹ G Wittwer and K Anderson 'How increased EU import barriers and reduced retail margins can affect the world wine market' (2001) *Centre for International Economic Studies, Wine Policy Brief* No.9, 2.

It is also argued that to maximise efficiency, a tax system should not impose any tax on goods and services as such a tax will reduce the level of demand leading to efficiency costs.¹⁰² On this basis, to minimise the efficiency costs of indirect taxes, the tax base should be broad so as to include all goods and services and one low rate of tax should be employed.¹⁰³ This will result in fewer changes in the consumption decisions by the impact of tax on the prices of goods and services.¹⁰⁴

The following table provides a basic comparison of the specific wine taxes on bottles of non-premium and premium wine in Australia, New Zealand and France (in Australian equivalent dollars).

Table 4: Comparison of A\$ tax equivalents on a 750ml bottle of unfortified wine

	A\$ tax equivalent on a A\$5 750ml bottle of wine¹⁰⁵	A\$ tax equivalent on a A\$15 750ml bottle of wine¹⁰⁶
Australia WET¹⁰⁷	0.75	2.25
New Zealand Excise	1.46	1.46
France Excise	0.05	0.05

France, with its minimal level of excise appears to have the most efficient specific wine tax. Australia's WET is significant as seen by the WET of approximately \$2.25 on a 750ml bottle of unfortified still wine that retails for \$15 (15 percent of retail price). A non-premium bottle retailing for \$5 will be subject to WET of approximately \$0.75 (15 percent of retail price). In Australia alcohol accounts for just under 2 percent of household consumption but it produces about 9 percent of the tax revenue from goods and services.¹⁰⁸ As the Australia's 2009 Tax Review notes, such specific taxes are 'generally less efficient as they also distort production decisions'.¹⁰⁹ It is likely that Australian consumers would gain from removal of the WET with improved quality wine, reductions in price (per same quality), increases in wine varieties, access to more wine imports and their ability to substitute other alcoholic drinks for wine.

¹⁰² Above n 94, 278.

¹⁰³ Above n 94, 277.

¹⁰⁴ Above n 94, 277.

¹⁰⁵ Australian Customs Service, 'Exchange rates week ending 18/11/08'

<http://www.customs.gov.au/site/page.cfm?u=4277>, Published exchange rates as at 18 November 2008, A\$1 = €0.511 or A\$1 = NZ\$1.1641.

¹⁰⁶ Above n 105.

¹⁰⁷ Winemaker's Federation of Australia, 'Australian wine: regional, sustainable essential' (2008): The Winemaker's Federation of Australia estimates that the wholesale price for a bottle that retails for \$15 would be \$7.75 per bottle, and that the WET (29% of the wholesale sale value) would account to 15% of the retail price. On this basis this analysis assumes that WET accounts for 15% of the retail price.

¹⁰⁸ Above n 94, 278.

¹⁰⁹ Above n 94.

New Zealand's excise tax is significantly higher for non-premium wine than Australia (29 percent of retail price) but the excise for premium wine is less than the WET (10 percent of retail price).

1. Wine Tax: Volumetric or ad valorem tax?

The comparison in Table 4 also highlights the impact of imposing volumetric (such as New Zealand's and France's excise tax) as opposed to ad valorem taxes (Australia's WET). This issue has been at the centre of some stern tax debates within the Australian wine industry as evident with the introduction of the 10 percent GST and the WET in Australia.¹¹⁰

As evident in Table 4, the volumetric excise tax on wine results in higher prices on non-premium wine whilst the ad valorem WET tax results in higher levels of tax on premium wine. Given the relatively low price of Australia's domestically consumed wine, the Centre for International Economic Studies (CIES) modelled that a volumetric tax could increase the price of wine by up to 50 percent.¹¹¹ The shift to premium wine would result in a loss of employment of about 6 percent in non-premium wine areas (Riverland, Murray Valley and Riverina).¹¹² Thus the Winemakers' Federation of Australia (WFA) opted for an ad valorem tax. However, premium wine makers were disadvantaged and some sectors of the wine industry were critical of the WFA decision (Western Australian and Tasmanian wineries).¹¹³ Given the world wide trend for greater consumption of premium wines the WET maybe counter productive. New Zealand's volumetric excise on wine, though, would have an adverse impact on non-premium wine producers.

2. Other WET Issues

Since the WET only applies to domestic sales it provides a big incentive for smaller producers to focus on the domestic market rather than export.¹¹⁴ This has resulted in Australian wines selling for less than \$2 per bottle given that producers pass on the rebate to consumers in lower wholesale prices. Given the lower profitability of exports under the WET some producers sought to increase the price of exported wine and thus struggle.¹¹⁵ Some winemakers argue that WET pushes them into exporting before they are ready.¹¹⁶

3. Correcting Externalities

A specific tax, though, can increase market efficiency if it reflects the external costs that the goods impose on the community.¹¹⁷ Thus, it is argued that

¹¹⁰ Above n 5, 100-103.

¹¹¹ G Wittwer and K Anderson, 'Tax reform and the Australian wine industry' (1998) *Centre for International Economic Studies*, University of Adelaide.

¹¹² Above n 5, 95-96.

¹¹³ Above n 5, 95-96.

¹¹⁴ G Cora 'Exporting wine in a competitive world' (2007) paper prepared for Outlook 2007, Canberra, 9.

¹¹⁵ Above n 114.

¹¹⁶ Above n 5, 101.

¹¹⁷ Above n 94, 279.

a tax on wine / alcohol will ensure that users or producers will incorporate the negative affect of alcohol when making consumption or production choices.¹¹⁸ The negative affect includes the health costs from alcohol related road accidents and alcohol abuse. The use of specific taxes on alcohol will allow consumption to achieve a socially optimal point.¹¹⁹

However, this argument is offset by a number of factors. The health costs of alcohol abuse are generally incurred by the consumer rather than taxpayers.¹²⁰ There appear to be benefits associated with the moderate consumption of wine.¹²¹ Renaud found that the French's high consumption of fats but low incidence of heart disease may be explained by their high wine consumption.¹²² Also, Kinesella proposed that the natural anti oxidant phenolic compounds of wine may protect against heart disease.¹²³ Additionally, targeted regulation and public advertising campaigns may be preferable to minimise alcohol abuse.

Further, corrective taxation is most efficient when the external costs are taxed directly,¹²⁴ that is, by targeting the people who abuse alcohol. This can be achieved to some extent through the effective enforcement of anti drink driving rules and associated fines and penalties. The use of excises or a WET are blunt instruments that impact widely throughout the community. Also, if a specific tax on wine was thought to be justified on this basis, then the tax would need to be based on the alcohol content and not its value. Under the WET the tax is based on the value of the wine and for many small producers no WET applies at all. Overall, the argument for wine tax on externality reasons appears to be some what contentious.

C Equity

Equity concerns the degree of fairness of the taxation laws. A widely accepted and fundamental principle of social justice demands equal treatment for people in similar circumstances (this is known as horizontal equity).¹²⁵ Horizontal equity requires the determination of a tax base, to measure similar circumstances so that an appropriate amount of tax can be imposed on a taxpayer. Accordingly, most commentators¹²⁶ have defined the tax base in terms of a taxpayer's ability to pay. Ability to pay could be based on income or wealth or a combination thereof. To ensure equity, the tax base should be defined as comprehensively as possible, so as to include both income and wealth.

As horizontal equity concerns the equal treatment of equals, as a corollary, vertical equity is required to ensure that tax imposed on people in different

¹¹⁸ Above n 94, 279.

¹¹⁹ Above n 94.

¹²⁰ Above n 5, 98.

¹²¹ Above n 5.

¹²² S Renaud & M De Lorgeril 'Wine, alcohol, platelets and the French paradox for coronary heart disease' (1992) *Lancett*: 339, 1523-1526.

¹²³ J E Kinsella, E N Franknell, J B German and J Kanner, 'Possible mechanisms for the protective role of antioxidants in wine and plant foods : physiological mechanisms by which flavonoids, phenolics, and other phytochemicals in wine and plant foods' (1993) 47 *Food Tech* 85-89.

¹²⁴ Above n 94, 280.

¹²⁵ R Krever and N Brooks, *A capital gains tax for New Zealand* (1990), 43.

¹²⁶ DF Bradford, *Untangling the Income Tax* (1986), 150-51.

circumstances is also fair.¹²⁷ Vertical equity requires both progressive income tax rates and a tax based on the “ability to pay”.

Indirect taxes have a very regressive impact as such taxes are not based on one’s ability to pay. Those on lower incomes pay a larger proportion of their income on indirect taxes. The following Australian Bureau of Statistics survey compares household expenditure on alcohol for five (low to high) gross income quintiles:¹²⁸

Table 5: Australian Bureau of Statistics Household Expenditure Survey: Alcoholic Beverages Expenditure and Gross Income Quintiles 2003-04

	Gross Income Quintiles				
	1	2	3	4	5
<i>Expenditure relative to Income:</i>					
Alcoholic Beverages (percent)	3.3	2.5	2.4	1.9	1.7

The above table shows that low income earners spend about twice as much of their income (as a percentage) on alcohol as people in the highest income quintile. This underlines the regressive impact of taxing alcohol at higher rates.

D *Simplicity*

The most rigorous and the generally accepted measure of simplicity seeks to identify the operating costs of a tax law.¹²⁹ Operating costs consist of the compliance costs of taxpayers and the administration costs of the Government.¹³⁰ Simplicity can, theoretically at least, be measured by estimating these operating costs, and dividing this amount over the amount of tax revenue.¹³¹ It follows that simplicity will improve where the operating costs or this ratio falls.

Compliance costs can be defined as the costs “incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax.”¹³² These costs will include the costs of keeping records, preparing taxation financial statements and taxation returns, obtaining tax advice, undergoing tax audits, tax planning and disputes. Taxation administration can be categorised into four types of Government activities: tax policy, design and planning, tax law drafting and enactment, Australian Taxation Office costs, and tax dispute resolution.¹³³

¹²⁷ Above n 125, 43.

¹²⁸ Australian Bureau of Statistics Household Expenditure Survey: Detailed Expenditure Items Australia 2003-04, ABS Cat No 6530.0, Tables 2, 4.

¹²⁹ B Tran-Nam, ‘Tax Reform and Tax Simplicity: A New and ‘Simpler’ Tax System?’ (2000) 23 *University of New South Wales Law Journal*, 244-246.

¹³⁰ Above n 129, 245.

¹³¹ Above n 129.

¹³² C Sandford, M Godwin and P Hardwick, *Administrative and compliance costs of taxation* (1989), 10.

¹³³ B Tran-Nam, ‘Assessing the Revenue and Simplification Impacts of the Governments Tax Reform’ (1999) 2 *Journal of Australian Taxation*, 332-333.

However, there is no known quantification of the compliance and administration costs associated with wine taxes in Australia, New Zealand and France. The greater the number of layers of indirect tax on wine, though, the greater the level of complexity. This means higher levels of compliance costs for the wine industry and administration costs for governments.

Australia's WET provides a vivid example of the complexity involved with imposing another layer of tax on wine. The complexity of the WET is evident from the above overview and from Diagram 1. This is also evident from the number of Australian Taxation Office (ATO) publications on the WET as follows:

Australian Taxation Office (ATO) Publications on WET

ATO Rulings

- WET Ruling 2002/1: The WET rulings system
- WET Ruling 2004/1: The operation of the wine equalisation tax system
- WET Ruling 2006/1: The operation of the producer rebate for producers of wine in New Zealand

Fact Sheets

- Overview of Wine equalisation tax
- Excise - wine fortification NAT 15677
- What is mead?
- Wine equalisation tax - packaging of wine by retailers
- Wine equalisation tax - quoting for GST-free supplies
- Wine equalisation tax - wine export and re-entry
- Wine equalisation tax (WET) - associated producers
- Wine equalisation tax (WET) - wine producer rebate
- Wine equalisation tax - frequently asked questions

Forms

- Application for refund of wine equalisation tax Nat 9241
- Approved quoting forms

How to complete your business activity statement

- Wine equalisation tax - how to complete your activity statement Nat 7390
- Wine equalisation tax and the business activity statement for wine producers
- Wine equalisation tax and the business activity statement for wine retailers

New Zealand WET rebate

- Application for approval as a New Zealand participant for a wine equalisation tax rebate NAT 15344
- Application for payment of wine equalisation tax rebate by an approved New Zealand participant NAT 14199

- WET Ruling 2006/1: The operation of the producer rebate for producers of wine in New Zealand
- Wine equalisation producer rebate calculation sheet for New Zealand wine producers NAT 15345
- Calculation sheet for New Zealand wine when values are expressed in New Zealand currency NAT 15345.
- Wine equalisation tax - producer rebate for New Zealand wine producers NAT 15256
- Wine equalisation tax (WET) - foreign currency conversions for New Zealand wine producers NAT 15346

Many of these publications are highly technical and lengthy. For example, WET Ruling 2004/1¹³⁴ on the operation of the wine equalisation tax system runs to some 146 paragraphs.

From a simplicity point of view it is preferable to only apply one layer of indirect tax to wine. Preferably, such a wine tax would be part of a comprehensive indirect tax base with a common tax rate such as a GST / VAT. This would remove a layer of tax law and the use of a uniform rate would remove the problem of having to classify goods against a range of taxation rates and / or structures. From a simplicity point of view the wine excises and the WET should be repealed. A minimal increase in the general rate of the GST / VAT could be enacted to replace the forgone revenue.¹³⁵

VIII TARIFFS

Tariffs such as customs and import duties provide tax revenue and are also a form of industry assistance to protect domestic firms from import competition.¹³⁶ They enable local firms to charge higher prices on the domestic market than otherwise possible and / or to increase their sales.¹³⁷ Thus, these tariffs benefit the owners and employees of protected domestic producers at the expense of domestic consumers who bare the higher prices and the foreign competitors who lose sales and profits. Tariffs also levy costs on domestic firms that use imported products subjects tariffs or buy goods from domestic producers who use inputs that are subject to tariffs.¹³⁸

Whilst tariffs were historically an important source of Australian tax revenue their importance has declined as other taxes have grown.¹³⁹ Tariffs are now used as a form of industry assistance¹⁴⁰ and it is beyond the scope of this paper to apply any trade policy analysis. However, all three countries provide some level of protection for their wine industry.

The industry assistance provided to the Australian wine industry is significant given the combined impact of the 5 percent customs duty and the 29

¹³⁴ Australian Taxation Office, Wine Equalisation Tax Ruling WET Ruling 2004/1: 'The operation of the wine equalisation tax system'.

¹³⁵ Above n 97.

¹³⁶ Above n 94, 282.

¹³⁷ Above n 94.

¹³⁸ Above n 94.

¹³⁹ Above n 94.

¹⁴⁰ Above n 94.

percent WET that applies to imported wine (excluding New Zealand wine). Foreign competitors (apart from New Zealand) cannot access the producers' WET rebate.

New Zealand also provides industry assistance through its 7 percent customs duty that applies to imported wine (excluding Australian wine). France through the EU tariffs policy provides some industry assistance. Additionally, concerns are also raised about non-tariff and technical barriers in the EU that stymie Australian and New Zealand wine exports.¹⁴¹

IX CONCLUSION

Reflecting different economic, social, cultural and historical factors all three countries have adopted different models for taxing wine. The policies range from the low taxing policies of France to the higher taxing Australian model.

From a tax policy perspective, imposing a specific indirect tax on wine such as an excise or a WET only minimally assists fiscal adequacy. However, on economic efficiency grounds a specific wine tax will damage efficiency as it distorts the decisions of producers and consumers. A wine tax appears to be a very blunt instrument to correct public externalities. Targeted regulation and public health campaigns could be employed to minimise alcohol abuse. Further, the regressive impact of such a tax clearly damages the equity criterion. Imposing another layer of indirect tax law on wine such as an excise duty or WET impedes simplicity. The New Zealand Tax Review 2001 concluded that wine excises could not be justified on tax efficiency or tax equity grounds.¹⁴² While the New Zealand Review found that wine excise could be justified on externality grounds, such a tax should be well below the excises currently imposed.

Most of the tax policy criteria (economic efficiency, equity and simplicity) appear to be damaged by specific taxes on wine. Whilst specific taxes on wine could be justified on revenue raising grounds the costs of the policy trade offs appear to be significant. In particular, the type of wine tax (volumetric or ad valorem tax) raises special concerns for a wine industry given its differential impact on non-premium and premium producers. Overall, it appears to be difficult to justify the imposition of specific taxes on wine on tax policy grounds, especially for significant wine producing countries. If externalities are a concern non-tax policies could be employed to counter these issues.

¹⁴¹ Above n 111, 3.

¹⁴² Above n 97, v.

APPENDIX 1: INTERNATIONAL WINE BACKGROUND

A Wine Production

In 2005 the top ten wine producer countries were:¹⁴³

Table A1: Top ten wine producers in 2005

Country	mhl	% of world total
Italy	54,021	19
France	52,105	18
Spain	36,158	13
United States	22,888	8
Argentina	15,222	5
Australia	14,301	5
China	12,000	4
Germany	9,153	3
South Africa	8,406	3
Chile	7,886	3
World total	282,276	

The old world wine countries, France, Italy and Spain also dominate wine production, followed by the new world wine countries such as United States, Argentina, Australia and China. New Zealand produced 1,020 mhl (0.3 percent of the world total) in 2005.¹⁴⁴

From 1990 to 2005, Australian wine production increased from 3,800 mhl to 14,301 mhl, an almost four times increase.¹⁴⁵ New Zealand has similarly experienced a rapid expansion of its wine industry. From 1990 to 2005, wine production virtually doubled from 544 mhl to 1,020 mhl.¹⁴⁶

B Wine Consumption

Over the period 1971 to 1985, world wine consumption was static at about 282,000 mhl (thousands of hectolitres).¹⁴⁷ From 1986 to 1990 this had fallen to approximately 240,000 mhl,¹⁴⁸ a fall of 15 percent. From 1991 to 2002 this further decreased to approximately 226,000 mhl,¹⁴⁹ a fall of 20 percent from the 1971-85 period. An uptrend began in 2003, with wine consumption from 2003-05

¹⁴³ International Organisation of Vine and Wine, 'Situation report for the world vitivinicultural sector' (2005) http://news.reseau-concept.net/pls/news/p_entree?i_sid=&i_type_edition_id=20508&i_section_id=20510&i_lang=33

, 30.

¹⁴⁴ Above n 143, Annexe F.

¹⁴⁵ Above n 143, Annexe F; Above n 143, 2.

¹⁴⁶ Ministry of Agriculture and Forestry, 'Review of Wine Legislation' (2000), Wellington, New Zealand, 22; Above n 143, 2.

¹⁴⁷ Above n 143, 15.

¹⁴⁸ Above n 143.

¹⁴⁹ Above n 143.

averaging approximately 237,000 mhl.¹⁵⁰ Nevertheless, these figures suggest that world wine consumption appears to be declining over the long term. Not surprisingly, given the decline in world wine consumption noted above, the total of world vineyards have fallen from an average of 9,961,000 hectares (ha) from 1971-75 to 7,929,000 ha in 2005, a decrease of 20 percent.¹⁵¹ Relevantly, the non-premium market for world wine is shrinking but the premium side is expanding.¹⁵²

In 2005 the top ten wine consuming countries were:¹⁵³

Table A2: Top ten wine consuming countries in 2005

Country	mhl	% of world total	Population ¹⁵⁴
France	33,530	14	64,420,073
Italy	27,016	11	58,126,212
United States	25,110	11	307,212,123
Germany	19,848	8	82,329,758
Spain	13,686	6	40,525,002
China	13,500	6	1,338,612,968
United Kingdom	12,000	5	61,113,205
Argentina	10,972	5	40,913,584
Russia	10,500	4	140,041,247
Portugal	4,900	2	10,707,924
World total	237,674		

The old world European wine countries (France, Italy, Germany and Spain) and one new world wine country (United States) dominate world wine consumption. Whilst Australia only consumed 4,523 mhl (1.9 percent of world consumption) and New Zealand 0.8 mhl (0.3 percent of world consumption) in 2005.¹⁵⁵

¹⁵⁰ Above n 143.

¹⁵¹ Above n 143, 5.

¹⁵² G Wittwer and K Anderson, 'How increased EU import barriers and reduced retail margins can affect the world wine market' (2001) *Centre for International Economic Studies*, 2.

¹⁵³ Above n 143, 30, Annexe 1.

¹⁵⁴ U.S. Census Bureau, *International Data Base*, <http://www.census.gov/ipc/www/idb/ranks.php>.

¹⁵⁵ Above n 154.

C *Wine Exports*

Also, in 2005 the top ten wine exporting countries were:¹⁵⁶

Table A3: Top ten wine exporters in 2005

Country	mhl	% of world total
Italy	15,721	20
Spain	14,439	18
France	14,077	18
Australia	7,019	9
Chile	4,209	5
United States	3,459	4
Germany	2,970	4
South Africa	2,811	4
Portugal	2,620	3
Moldova	2,425	3
World total	79,738	

Again, the old world wine countries, France, Italy and Spain lead world wine exports followed by new world wine countries, Australia, Chile, United States. In 2005 New Zealand exported 514 mhl of wine (0.6 percent of world total). France though is the number one exporter by value with 35.1 percent share of the world wine market with total exports valued at \$6.8 billion.¹⁵⁷

Overall, in 2005, the old world countries, France, Italy and Spain remain dominant in the consumption, production and export of wine. However, over the last 20 years there has been a shift in wine production from old to new world countries. In 1975, France, the leading wine producer, had a 50 percent global market share by value and it is predicted that this share will fall to 25 percent by 2010.¹⁵⁸ Notably, just three countries, Germany, United Kingdom and United States import 41 percent of world wine.

From 1990 to 2005 Australia became a net exporter of wine and exports increased from 380 mhl to 7,019 mhl, more than a 17 times increase.¹⁵⁹ Outside of Europe, Australia is the largest exporter of wine but only accounts for 5 percent of world wine production.¹⁶⁰ Given the decline in the global wine industry this is strong performance was achieved by growing market share against other competitors. In 2006 the United Kingdom and the United States purchased the vast majority of the exported wine (65 percent of volume).¹⁶¹ Canada with 7 percent is the third largest export market.¹⁶²

¹⁵⁶ Above n 154.

¹⁵⁷ Australian Wine and Brandy Corporation, 'Wine in Europe'
<http://www.wineaustralia.com/australia/Default.aspx?tabid=873>.

¹⁵⁸ Above n 157.

¹⁵⁹ Above n 157.

¹⁶⁰ Above n 157.

¹⁶¹ Above n 114, 3.

¹⁶² Above n 114.

The United Kingdom market is important for low to medium quality wine but commentators view it as the most competitive.¹⁶³ There is a trend for major retailers to switch to buyers own brands (they account for 48 percent of the market). In the United States the demand for Australian boutique wine is strong and one non-premium wine (Yellowtail) is experiencing strong growth.¹⁶⁴ The demand in Canada for Australian wine is growing strongly.¹⁶⁵ Asia is viewed as having prospect as a long term wine export destination.¹⁶⁶ However, increased levels of competition are expected in these major wine markets and other markets.¹⁶⁷ European countries that have received subsidies to revamp vineyards, and production is expected to increase from California, Chile, Bulgaria and South Africa.¹⁶⁸

From 1990 to 2005, New Zealand wine exports increased from 40 mhl to 514 mhl, more than a 12 times increase.¹⁶⁹ In 2006, United Kingdom, United States and Australia purchased the vast majority of the exported wine (84 percent).¹⁷⁰

D Wine Imports

In 2005 the top ten wine importing countries were:¹⁷¹

Table A4: Top ten wine importing countries in 2005

Country	mhl	% of world total
Germany	13,262	17
United Kingdom	11,727	15
United States	7,052	9
Russia	6,227	8
France	5,495	7
Netherlands	3,799	5
Belgium	2.9	4
Canada	2,897	4
Italy	1,833	2
Switzerland	1,813	2
World total	772,286	

¹⁶³ Above n 114.

¹⁶⁴ Above n 114, 4: Ten million cases were sold in 2007. The United States / Australian Free Trade Agreement will have a minor impact as the tariff reduction occurs over 15 years.

¹⁶⁵ Above n 114, 4.

¹⁶⁶ Korda Metha, 'Wine manufacturing, Industry vitals' (2007) Korda Metha Research Unit Publication 707, 11.

¹⁶⁷ Above n 114, 4.

¹⁶⁸ Above n 166, 9, 11.

¹⁶⁹ Above n 166, 9, 11.

¹⁷⁰ Investment New Zealand, 'New Zealand Wine Industry', 2007,

http://www.investmentnz.govt.nz/common/files/NZTE%20Wine%20Brochure_Low%20Res%20Apr07.pdf.

¹⁷¹ Above n 143, Annexe G.

Old world countries that are not significant wine producers, Germany and United Kingdom, head this list of importing nations. Australia only imported 221 mhl (0.02 percent of world total) and New Zealand 359 mhl (0.05 percent of world total) in 2005.¹⁷²

¹⁷² Above n 143, Annexe G.

UNDERSTANDING THE COMPLIANCE BEHAVIOUR OF MALAYSIAN INDIVIDUAL TAXPAYERS USING A MIXED METHOD APPROACH

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This article reports on the findings of a mixed method study that was conducted to investigate the impact of the introduction of self assessment on the compliance behaviour of individual taxpayers in Malaysia. The likely impact of this change was uncertain given inconclusive evidence in the literature on the effect of self assessment on compliance behaviour. The findings revealed that the introduction of self assessment had a positive influence on compliance behaviour. In particular, acquiring tax knowledge had significant effects on compliance behaviour. Taxpayers were found to be sensitive to tax audit and penalty. While financial constraints were found to have a more direct and stronger influence on the compliance behaviour of self-employed taxpayers, attitudes towards paying tax appeared to only affect salary and wage earner taxpayers.

I INTRODUCTION

Self assessment for individual taxpayers was first introduced in Malaysia for income derived in the 2004 year of assessment. Self assessment replaced the former official assessment system and shifted responsibility to individual taxpayers (both salary and wage earners and the self-employed) to file their returns on time, to accurately report all relevant information as required by law, to calculate their own tax liability and to pay any outstanding taxes by the due date. The adoption of self assessment by tax administrations is increasingly a global phenomenon and is evidenced in many jurisdictions including Australia, New Zealand, Canada, United Kingdom, Pakistan and Bangladesh. It is generally favoured as a means of reducing administration costs, improving voluntary compliance rates and facilitating tax collections.¹ However, for voluntary compliance rates to be maximised, taxpayers need to have a positive attitude towards taxation and to both understand, and be able to fulfil, their obligations. To reap the benefits of self assessment, the revenue authority needs to understand the compliance behaviour of its taxpayers. Further, the revenue authority needs to have appropriate systems and strategies in place to support those taxpayers who are willing to comply, to enforce compliance where taxpayers are less willing to comply voluntarily, and to encourage taxpayers to have a positive attitude towards paying taxes. Clearly, self assessment poses considerable challenges for both taxpayers and the revenue authority.

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¹ E C Loo, M McKerchar and A Hansford, 'An International Comparative Analysis of Self Assessment: What Lessons Are There For Tax Administrators?' (2005) 20(5) *Australian Tax Forum* 669.

The purpose of this article is to present findings from a mixed method study into the effect of the introduction of self assessment on the compliance behaviour of individual taxpayers in Malaysia. The study was expected to provide the Inland Revenue Board of Malaysia with a deeper understanding of the compliance behaviour of its taxpayers and to identify strategies that could be effective in improving the level of voluntary compliance. Further, the findings of this study would have relevance to other jurisdictions, particularly where the introduction of self assessment was under consideration.

The remainder of this article is set out in five parts. Following the introduction, a review of the compliance literature is presented in section II and a brief explanation of the research methodology is presented in section III. The findings of the study and a general model for compliance by individual taxpayers are presented in section IV. Conclusions, limitations of the study and areas for further research are discussed in section V.

II LITERATURE REVIEW

A considerable body of literature exists on taxpayer compliance and the factors thought to influence tax compliance behaviour have been investigated using a diverse range of models. These include economic deterrence models as first developed by Allingham and Sandmo;² the sociological/psychological models, particularly as developed by Ajzen and Fishbein³ and Ajzen⁴ as well as by Lewis;⁵ and the expanded models as proposed by Fischer, Wartick and Mark,⁶ and Chan, Troutman and O'Bryan.⁷ However, the gap between theory and reality still remains large.

Economic deterrence models assume that taxpayers are amoral rational economic evaders who assess the likely costs and benefits of evasion behaviour.⁸ Based on this underlying assumption, these models generally predict that an increase in perceived detection probability and/or penalties will result in greater taxpayer compliance⁹ while an increase in the tax rate will result in reduced

² M G Allingham and A Sandmo, 'Income Tax Evasion: A Theoretical Analysis' (1972) 1 *Journal of Public Economics* 323.

³ I Ajzen and M Fishbein, 'Attitude-Behaviour Relations: A Theoretical Analysis and Review of Empirical Research' (1977) 84(5) *Psychology Bulletin* 888; I Ajzen and M Fishbein, *Understanding Attitudes and Predicting Social Behaviour* (1980).

⁴ I Ajzen, *Attitudes, Personality and Behaviour* (1988).

⁵ A Lewis, *The Psychology of Taxation* (1982).

⁶ C M Fischer, M Wartick and M Mark, 'Detection Probability and Taxpayer Compliance: A Literature Review' (1992) 11 *Journal of Accounting Literature* 1.

⁷ C W Chan, C S Troutman, and D O'Bryan, 'An Expanded Model of Taxpayer Compliance: Empirical Evidence from the United States and Hong Kong' (2000) 9(2) *Journal of International Accounting and Taxation* 83.

⁸ S Klepper and D Nagin, 'The Role of Tax Preparers in Tax Compliance' (1989) 22 *Policy Sciences* 167; J Hasseldine, 'How Do Revenue Audits Affect Taxpayer Compliance?' (1993) July/August *International Bureau of Fiscal Documentation* 424.

⁹ C T Clotfelter, 'Tax Evasion and Tax Rates: An Analysis of Individual Returns' (1983) August LXV(3) *Review of Economics and Statistics* 363; A D Witte and D F Woodbury, 'The Effect of Tax Law and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax' (1985) 38(1) *National Tax Journal* 1; J C Baldry, 'Self Assessed Taxation in Australia: An Appraisal of Changes in Enforcement Procedures' (1999) March/April *Chartered Secretary Malaysia* 12.

compliance.¹⁰ However, while these models have provided valuable insights, there have been conflicting findings. It has been argued that compliance cannot be explained entirely by economic deterrence models¹¹ because they fail to incorporate other institutional realities.¹² Furthermore, economic deterrence models may be insufficient to guide tax administration policy given that they ignore social norms and non-monetary factors.¹³

Literature from the disciplines of sociology, psychology and law has consistently argued for a broader view of compliance behaviour. To enhance the economic models of compliance, researchers needed to explore psychology, moral and social influences on compliance behaviour and integrate these factors into their models.¹⁴

The sociological/psychological models are premised on the belief that social factors such as attitudes, level of education and knowledge appear to influence behaviour.¹⁵ Lewis¹⁶ argued that attitudes are products of myth and misperceptions and that any behaviour may represent a multiplicity of attitudes. Further, Lewis argued misperceptions could be substituted by knowledge. The importance of taxpayer attitudes in influencing compliance behaviour is also supported by Song and Yarbrough.¹⁷ They found that taxpayers' compliance was determined by the overall legal environment (the legitimacy of the tax law), the tax ethics of the citizen (understanding and acceptance of legal obligation) and other factors (such as level of income, unemployment rate, tax rate) operating at a particular time and place. Song and Yarbrough found that taxpayers with a higher fiscal knowledge had higher tax ethics. This is supported by Eriksen and Fallan¹⁸ who found that low fiscal knowledge correlated with negative attitudes towards taxation and that attitudes towards tax improved with better tax knowledge. In contrast, Beron, Tauchen and Witte¹⁹ found compliance to be higher for taxpayers who were less well educated and older, native born.

¹⁰ M M Ali, H W Cecil and J A Knoblett, 'The Effects of Tax Rate and Enforcement Policies on Taxpayer Compliance: A Study of Self-Employed Taxpayers' (2001) 29(2) *Atlantic Economic Journal* 186.

¹¹ M J Graetz and L L Wilde, 'The Economics of Tax Compliance: Fact and Fantasy' (1985) 38(3) *National Tax Journal* 55; C Silvani and K Baer, 'Designing a Tax Administration Reform Strategy: Experiences and Guidelines' (1997) August *Tax Notes International* 375.

¹² Fischer, Wartick and Mark, above n 6.

¹³ B R Jackson and V C Milliron, 'Tax Compliance Research: Findings, Problems, and Prospects' (1986) 5 *Journal of Accounting Literature* 125; J A Roth, J T Scholz and A D Witte, *Taxpayers Compliance, 1: An Agenda for Research* (1989); T J Casey and J T Scholz, 'Beyond Deterrence: Behavioural Decision Theory and Tax Compliance' (1991) 25(4) *Law and Society Review* 821; D D Bobek, R W Roberts and J T Sweeney 'The Social Norms of Tax Compliance: Evidence from Australia, Singapore and the United States' (2007) 74 *Journal of Business Ethics* 49.

¹⁴ P A Hite, 'A Positive Approach to Taxpayer Compliance' (1989) 44(2) *Public Finance* 249; J Andreoni, B Erard and J S Feinstein, 'Tax Compliance' (1998) 36(2) *Journal of Economic Literature* 818.

¹⁵ C Coleman, 'Changing Attitudes of Small Business Owners to the ATO in a Tax Reform Environment' (Paper presented at Australasian Tax Teachers' Association Conference, Canberra, 6 February 1999).

¹⁶ Lewis, above n 5.

¹⁷ Y Song and T E Yarbrough, 'Tax Ethics and Taxpayers Attitude: A Survey' (1978) 38 *Public Administration Review* 435.

¹⁸ K Eriksen and L Fallan, 'Tax Knowledge and Attitudes Towards Taxation: A Report on a Quasi-Experiment' (1996) 17(3) *Journal of Economic Psychology* 387.

¹⁹ K L Beron, H V Tauchen and A D Witte, 'A Structural Equation Model for Tax Compliance and Auditing' (Working Paper No 2556, National Bureau of Economic Research, 1988).

Whilst attitudes and education do appear to be key factors in influencing compliance behaviour, research findings have revealed mixed and inconsistent evidence. A compelling explanation for this is that there are many factors at play at any point in time and understanding how they influence human behaviour is extremely difficult, particularly when seeking to make generalisations about the broader population. Jackson and Milliron²⁰ used a meta-analysis to analyse the existing compliance literature from which they identified fourteen factors (age, gender, education, income level, income source, occupation, peer influence, ethics, fairness, complexity, revenue authority contact, probability of detection, sanction and tax rate) that to some extent did influence the compliance behaviour of taxpayers. There are many studies focused on various combinations of these factors.²¹ Further, more recently factors such as satisfaction with government;²² financial position;²³ willingness and opportunity;²⁴ and taxpaying culture²⁵ have emerged as influencing compliance behaviour.

This continued interest in compliance behaviour has led to further refinement of the economic and psychological-sociological models into the expanded models which integrate all known variables be they economic, psychological or sociological.²⁶ However, given the multitude of variables at play, it appears that even in the case of the expanded models, focusing on a limited number of variables and/or relationships and studying them in depth and/or at a point in time offers the best potential for gaining a better understanding of how taxpayers make their compliance decisions.

There appeared to be a gap in the literature on the impact of self assessment on compliance behaviour, thus its introduction in Malaysia afforded a unique research opportunity. In the context of Malaysian taxpayers, it was expected that self assessment would affect individual taxpayers more than other category of taxpayers, such as companies and other incorporated entities.²⁷ Accordingly, individual taxpayers were identified as the subjects for this research. A prior study conducted with Malaysian students found that a relationship existed

²⁰ Jackson and Milliron, above n 13.

²¹ See for example: G Schmolders, 'Survey Research in Public Finance-A Behavioural Approach to Fiscal Theory' (1970) 25 *Public Finance* 300; Roth, Scholz and Witte, above n 5; C M Ritsema, D W Thomas and G D Ferrier, 'Economic and Behavioural Determinants of Tax Compliance: Evidence form the 1997 Arkansas Tax Penalty Amnesty Program' (Paper presented at the IRS Research Conference, Washington, 10-11 June 2003); M McKerchar, *Complexity, Fairness and Compliance: A Study of Personal Income Taxpayers in Australia* (2003); J Kasipillai and A J Hijattulah, 'Gender and Ethnicity Differences in Tax Compliance' (2006) 11(2) *Asian Academy of Management Journal*, 73.

²² K W Smith and L J Stalans, 'Encouraging Tax Compliance with Positive Incentives: A Conceptual Framework and Research Directions' (1991) 13(1) *Law & Policy* 35; R Oberholzer, 'Attitudes of South African Taxpayers Towards Taxation: A Pilot Study' (2008) 7(1) *Accountancy Business and the Public Interest* 44.

²³ Ritsema, Thomas and Ferrier, above n 21.

²⁴ I G Wallschutzky, 'Taxpayer Decision Making: To Comply or Not to Comply? That is the Question' (Paper presented at Australasian Tax Teachers' Association Conference, 1990).

²⁵ B Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments' (2002) 16(5) *Journal of Economic Surveys* 657.

²⁶ Fischer, Wartick and Mark, above n 6; Chan, Troutman and O'Bryan, above n 7.

²⁷ E C Loo and J K Ho 'Self Assessment for Salaried Taxpayers: Taxpayers' Land Mine, Tax Agents' Gold Mine and Inland Revenue Board of Malaysia's Not Mine' (Paper presented at National Conference on Accounting and Finance, Putrajaya, 23-24 August 2004).

between education and tax compliance.²⁸ However, the extent to which these findings could be generalised to individual taxpayers was unknown. Hence the overarching objective of this research was to gain further insights into the influence of the introduction of self assessment (and in accordance with the expanded model approach, other possible causes) on the compliance behaviour of individual taxpayers in Malaysia. Based on the literature, five main categories of causes (namely the assessment system, tax knowledge, tax structure features, financial constraints and attitude towards tax) were identified, and together with the main cause (that is, self assessment) and one outcome (compliance behaviour), formed the focus of the research.

For the purposes of this study, each of these causes needs brief explanation in the context of Malaysia. 'Assessment system' refers to the change from the official assessment system to self assessment from 2001 for companies and from 2004 for other taxpayers. 'Tax knowledge' refers to a taxpayer's ability to correctly report his or her taxable income, claim relief and rebates, and compute tax liability. 'Tax structure' takes into consideration of tax rates, probability of audit and the penalty regime. 'Financial constraints' includes the level of income and number of dependants. 'Attitudes towards tax' refers to a taxpayer's confidence in handling his or her tax affairs; attitude towards the tax system and the tax administration.

In terms of compliance behaviour, a compliant taxpayer is one who submits or files his or her return within the stipulated deadlines, truthfully and accurately reports all relevant information pertaining to his or her tax liabilities and in accordance with the tax law, and pays the taxes due without the need for further enforcement by the tax agency.²⁹ A non-compliant taxpayer is one that fails to meet one or more of these obligations, either intentionally or unintentionally.³⁰

III METHODOLOGY

Given the scope of the research problem, it was felt that a single research paradigm would be insufficient to address the objective of this research. Thus a mixed method design using both the quantitative and qualitative paradigms was adopted. A mixed method design uses the advantages of both the quantitative and qualitative paradigms, allowing the researcher to work back and for between inductive and deductive models of thinking and reduces the bias inherent in a single method.³¹ A mixed method design is recognised as a superior approach and capable of providing more comprehensive answers than a single method design.³²

²⁸ J Kasipillai, N Aripin and N A Amran, 'The Influence of Education on Tax Avoidance and Tax Evasion' (2003) 1(2) *e-Journal of Tax Research* 134.

²⁹ J Alm, 'A Perspective on the Experimental Analysis of Taxpayer Reporting' (1991), 66(3) *Accounting Review* 577; V Singh 'Malaysian Taxation – Administrative and Technical Aspects' (2003).

³⁰ M McKerchar, 'The Effects of Complexity on Unintentional Non-compliance for Personal Taxpayers in Australia' (2002) 1 *Australian Tax Forum* 3.

³¹ J W Creswell *Research Design- Qualitative, Quantitative and Mixed Methods Approach* (2nd ed, 2003).

³² N K Denzin and Y S Lincoln (eds), *Handbook of Qualitative Research* (2nd ed, 2000); W L Neuman, *Social Research Methods, Qualitative and Quantitative Approaches* (5th ed, 2003).

Two quantitative strategies of inquiry (a survey and an experiment) and one qualitative strategy of inquiry (a case study) were implemented concurrently in three phases between November 2004 and July 2005. The findings of the three strategies can be consolidated and triangulated using cross-method analysis and this is essential so that the research problem and its questions can be addressed in their entirety, thus the focus in this paper is on the overall analysis and findings of the research as a whole.

The survey entailed a repeated cross-sectional design which was conducted both before and after the filing of tax returns at the time self assessment was first introduced. Broadly, the survey included tax factors (assessment system, tax structure, tax knowledge and attitude towards tax) and non-tax factors (those related to financial constraints such as marital status, number of dependents and income level) as determinants of individual taxpayers' compliance behaviour (see Table 1).

Table 1: Descriptions of the components of factors

Factors	Descriptions
Assessment system	Implications of the change of assessment system on the responsibility of Inland Revenue Board and taxpayers
AS1	Reduced responsibility of Inland Revenue Board
AS2	Increased responsibility of taxpayers
Tax knowledge	Tax knowledge of respondents in relation to joint assessment, S46 relief, child relief, rebates and some issues on tax returns
TK1	Understanding of joint assessment and S46 relief and rebates
TK2	Disabled child relief and others, principally S46 relief
TK3	Child relief
TK4	Understanding of a joint assessment, rebates and tax computation
TK5	Knowledge on extension (of deadline) and deduction
TK6	Relief for unmarried child, education fees, rebate on levy and deduction
Tax structure	Penalty and tax audit
TS1	Penalty for failure to file tax returns or for filing fraudulent tax returns
TS2	Strict enforcement and heavy penalty
TS3	Tax audit
Financial constraints	Financial situation of taxpayers in terms of marital status, income levels, number of dependents and use of tax agents
FC1	Family commitment (Marital status and dependents)
FC2	Level of income and use of services of tax agent
Attitude towards tax	Attitude of taxpayer towards tax in terms perception on the tax administration, benefits gain from taxes paid and level of confidence in handling tax matters
AP1	Principally on issue related to tax administration, moral/ethical obligations
AP2	Level of confidence in handling tax
AP3	Understanding of tax law, moral/ethical obligations, transparency of tax administration, fair share gained
AP4	Perception on Inland Revenue Board officers and fair share of tax revenue
Tax knowledge	Knowledge on business deduction and receipts for self employed
KB1	Expenses incurred on staff welfare, entertainment and fire insurance premium; and depreciation
KB2	Expenses incurred on interest, staff welfare and entertainment
KB3	Expenses incurred on interest, staff welfare, entrance fees and free gift; and capital allowances
KB4	Expenses incurred on interest, free gift; capital allowances and receipts/compensation from disposal of assets
KB5	Receipts/compensation from disposal of assets
KB6	Private expense and donation
KB7	Depreciation and dual purpose expenses

The non-tax factors also included the demographics of the individual taxpayers (such as gender, level of education, occupation, age and ethnic group) that may have mediating effects on the determinants of compliance behaviour. The survey (in both Malay and English languages) was distributed by mail to randomly selected (using local telephone directories) salary and wage earners and the self-employed. A covering letter was included that described the nature of the

survey, guaranteed complete anonymity, and emphasised that the survey was not conducted by or on behalf of the Inland Revenue Board of Malaysia. Of the 6,000 surveys randomly distributed, 800 usable responses were received. While the response rate was lower than expected, it was considered sufficient for statistical analysis to be undertaken.³³ An ordinal stepwise logistic regression analysis with logit function (as in generalised linear model techniques) was utilised to analyse the relationship between the dependent variables (reporting compliance) and the independent variables (tax and non-tax factors).

A quasi-experimental research approach known as 'one group pre-test post-test' design was used for the experiment in which four hypotheses were tested.³⁴ Two main groups of undergraduate students (125 in total) were chosen to participate in the experiment, using two different simulation packages. In addition to the simulation package provided, participants were informed of the possibility of being audited and the respective penalties imposed. For the purpose of this research the two different groups were taken to represent the two main target groups of individual taxpayers (that is, salary and wage earners and the self-employed). Given the lack of an appropriate control group, the only comparison available would be the pre-test and the post-test within the same group. In order to investigate the interactions between the variables (namely the pre-test score, audit rate, penalty rate and the effects of lessons on tax knowledge on the post-test score of participants), ANOVA was used.

A common shortcoming of much tax compliance research is that it is generally based on self-reported, simulated or hypothetical behaviour. To address this shortcoming, a case study was designed and conducted with seventy four participants. The case study was based on the model developed by Yin³⁵ where individual cases (comprised of in depth interviews, inspection of records, and in situ observations by the researcher) are repeated and analysed for emerging patterns that will allow theories to be developed. This method is considered best able to explain the causal links in real life interventions that are too complex for survey or experimental design.³⁶ This strategy provided indications of the influence of self assessment based on actual behaviour as close as possible to the time of occurrence, judged objectively based on a wider range of information obtained (that is, the examination of the actual tax returns, taxpayers' records and documents as well as the systematic interviewing of taxpayers).³⁷ Pattern matching logic was employed to compare an empirically based pattern with a predicted one as well as identifying other possible causes that emerged from the data collected. The findings of the three research methods (namely a survey, an experiment and case study) above were consolidated and triangulated using a cross-method analysis.

³³ E C Loo, M McKerchar and A Hansford, 'The Effect of the Introduction of Self Assessment on Tax Knowledge of Individual Taxpayers in Malaysia: Survey Findings' (Paper presented at Accounting Studies International Conference 2007, Kuala Lumpur, 30-31 October 2007).

³⁴ E C Loo, 'Tax Knowledge, Tax Structure and Compliance: A Report on a Quasi-Experiment' (2006) 12(2) *New Zealand Journal of Taxation Law and Policy* 117.

³⁵ R K Yin, *Case Study Research-Design and Methods* (1989).

³⁶ *Ibid.*

³⁷ E C Loo, 'A Qualitative Case Study on the Impact of Self Assessment on Individual Taxpayers in Malaysia' (Paper presented at the Asian Academic Accounting Association Conference, Sydney, 17-20 September 2006).

IV FINDINGS

The key findings that emerged from the research were in respect of the impact of tax knowledge on compliance behaviour; the effect of penalties on compliance behaviour; the impact of financial constraints on compliance behaviour; the impact of taxpayers' attitude on compliance behaviour; and finally, the impact that the interaction of the various influences had on compliance behaviour. Discussion on each of these findings follows.

A The Effect of Self Assessment on Taxpayers' Understanding and Tax Knowledge

The introduction of self assessment led to improvements in individual taxpayers' understanding of the current assessment system and in their tax knowledge, and these improvements had had a positive influence on their compliance behaviour. For example, the subjects in the case study disclosed that they were more careful in filling in their tax returns to ensure accuracy and to avoid being penalised unnecessarily for unintentional errors or unintentional non-compliance.

The impact of the introduction of self assessment on compliance behaviour was closely linked to the level of tax knowledge that a taxpayer acquired. The findings of the experiment (see Tables 2, 3 and 4) and the case study showed that the lack of tax knowledge did cause numerous errors in the tax returns furnished by those who prepared their own. These errors resulted in unintentional non-compliance. Similarly, ignorance of certain exemptions and deductions available had resulted in over compliance that obviously favoured the tax authority. Other than for a few exceptions, generally the subjects in the case study exhibited commitments to comply with the income tax law if furnished with adequate tax knowledge. Likewise, the outcomes of this research (specifically, the experiment) also suggested that taxpayers would have better reporting compliance when they had better tax knowledge. However, it must be acknowledged that for some taxpayers, having more tax knowledge could enable them to exercise better tax planning in terms of tax avoidance and some might even venture into the domain of tax evasion.

Table 2: Analysis of variance with four factor interaction - salary and wage earners, and self employed

Source of variation	d.f.	s.s	m.s	F	p-value
Variate: Score					
Test	1	88175.65	88175.65	1699.27	<0.001**
Audit rate	1	466.22	466.22	8.98	0.003**
Penalty rate	1	977.88	977.88	18.85	<0.001**
Tax rate	2	1870.94	935.47	18.03	<0.001**
Category x test x audit rate	1	254.94	254.94	4.91	0.028*
Category x test x penalty rate	1	14.66	14.66	0.28	0.596
Category x audit rate x penalty rate	1	164.81	164.81	3.18	0.076
Test x audit rate x penalty rate	1	91.10	91.10	1.76	0.187
Category x test x tax rate	2	783.25	391.63	7.55	<0.001**
Category x audit rate x tax rate	2	567.49	283.74	5.47	0.005**
Test x audit rate x tax rate	2	315.26	157.63	3.04	0.050*
Category x penalty rate x tax rate	2	436.69	218.35	4.21	0.016*
Test x penalty rate x tax rate	2	106.04	53.02	1.02	0.362
Audit rate x penalty rate x tax rate	2	397.93	198.96	3.83	0.023*

** Significant at 0.01 levels, *Significant at 0.05 levels

Table 3: Analysis of variance with two-factor interaction for salary and wage earners

Source of variation	d.f.	s.s	m.s	F	p-value
Variate: Score					
Test x audit rate	1	91.39	91.39	0.94	0.332
Test x penalty rate	1	433.16	433.16	4.47	0.036*
Audit rate x penalty rate	1	213.23	213.23	2.20	0.139
Test x tax rate	2	280.77	140.39	1.45	0.237
Audit rate x tax rate	2	1203.68	601.84	6.21	0.002*
Penalty rate x tax rate	2	190.65	95.32	0.98	0.375

*Significant at 0.05 levels

Table 4: Analysis of variance with four factor interaction for the self employed

Source of variation	d.f.	s.s	m.s	F	p-value
Variate: Score					
Test x audit rate x penalty rate	1	9.57	9.57	0.40	0.528
Test x audit rate x tax rate	2	19.44	9.72	0.41	0.667
Test x penalty rate x tax rate	2	277.08	138.54	5.80	0.004*
Audit rate x penalty rate x tax rate	2	618.41	309.20	12.95	<0.001*

*Significant at 0.05 levels

Regardless of the type of compliance behaviour, the effect of tax knowledge on individual taxpayers' compliance behaviour remained robust and prevalent. As such, the findings of this research had contributed new evidence to

the existing literature³⁸ in finding the existence of a positive relationship between tax knowledge and tax compliance.

B The Effect of Penalties on Compliance Behaviour

This research also revealed information concerning taxpayers' reactions to the enforcement strategies currently used by the Inland Revenue Board of Malaysia, particularly in respect of tax audit and penalty. To a certain extent, these two enforcement strategies could be effective deterrence tools (see Appendix, Table 5 and Tables 2, 3 and 4, above). For instance, evidence gathered from the subjects of the case study revealed that fear of being tax audited and of being penalised had indirectly influenced the subjects' decisions to comply with the tax law. Even though there were expressions of dissatisfaction among the subjects within both the higher and the lower tax brackets, fear of the possibility of being tax audited and of the imposition of penalty had led some subjects to be over cautious and over comply. However, it needs to be noted that not all taxpayers were alike in terms of how tax audit or penalty affected their compliance behaviour, particularly those who were salary and wage earners (see Table 6). For the salary and wage earners (of whom withholding tax was imposed on their employment income), tax audit was a less effective tool, as the majority of these subjects confessed that they were keen to file their returns in order to get the refund of their over withheld taxes. Nevertheless, the findings of this research have added to the body of evidence³⁹ that economic models do have significance in contributing to the understanding of tax compliance behaviour in real world settings.

³⁸ Fischer, Wartick and Mark, above n 6; A L Christensen, S G Weihrich and M D G Newman, 'The Impact of Education on Perceptions of Tax Fairness' (1994) 6 *Advance in Taxation* 63; J Kasipillai et al, 'Are Malaysian Taxpayers Prepared For the Self Assessment System?' (1999) September *Tax National* 9; Chan, Troutman and O'Bryan, above n 7; N Saad, M Mansor and I Ibrahim, 'The Self-Assessment and its Compliance Costs' (Paper presented at SEMAAC 2003 Research Proceeding: Issues and Challenges Confronting the Accounting Profession Today, Kangar, Malaysia, 8-10 December 2003); E Groenland and G VanVeldhoven, 'Tax Evasion Behaviour: A Psychological Framework' (1983) 3 *Journal of Economic Psychology* 129.

³⁹ See for example N Friedland, S Maital and A Rutenberg, 'A Simulation Study of Income Tax Behaviour' (1978) 10 *Journal Public Economics* 107.

Table 5: Factors associated with reporting of taxable income - salary and wage earners, and self employed

Estimates of parameters and accumulated analysis of deviance

Parameter	d.f.	estimate	s.e.	t	t pr.	mean deviance	deviance ratio	Approx chi pr
Cut-point 0/1		1.09	1.13	0.96	0.335			
Cut-point 1/2		3.79	1.15	3.31	<.001			
TK4	1	0.1449	0.0706	2.05	0.040*	29.342	29.34	<.001***
TS1	1	0.0659	0.0318	2.07	0.039*	9.638	9.64	0.002**
A4	3					3.681	3.68	0.011*
A4 2		-0.669	0.238	-				
				2.81	0.005**			
A4 3		-0.050	0.258	-	0.846			
				0.19				
A4 4		-0.997	0.437	-	0.022*			
				2.28				
A2	1					5.455	5.45	0.020*
A2 2		0.957	0.420	2.28	0.023*			
TK1	1	0.0501	0.0328	1.53	0.126	3.470	3.47	0.062^
A14	4					2.022	2.02	0.088^
A14 2		0.017	0.640	0.03	0.978			
A14 3		0.511	0.616	0.83	0.407			
A14 4		0.647	0.637	1.02	0.310			
A14 5		1.316	0.844	1.56	0.119			
AP4	1	-0.1602	0.0666	-	0.016*	3.536	3.54	0.060^
				2.41				
AP3	1	0.1043	0.0608	1.72	0.086^	2.639	2.64	0.104
A1	1					1.964	1.96	0.161
A1 2		-0.251	0.191	-	0.190			
				1.31				
AP2	1	-0.0213	0.0158	-	0.177	1.341	1.34	0.247
				1.35				
TK5	1	0.0678	0.0594	1.14	0.253	1.259	1.26	0.262
Residual	451					1.779		
Total	467					1.885		

Significant level: *** $p < 0.001$, ** $p < 0.01$, * $p < 0.05$, ^ $p < 0.10$

Parameters for factors are differences compared with the reference level:

Factor	Reference level
A4 (Age)	1 (21 -30 years)
A2 (Language Proficiency)	1 (Malay Language & English)
A14 (Levels of Tax Knowledge Rated)	1 (Extremely Good)
A1 (Gender)	1 (Male)

Table 6: Factors associated with reporting of taxable income – salary and wage earners

Estimates of parameters and accumulated analysis of deviance

Parameter	d.f.	estimate	s.e.	t	t pr.	mean deviance	deviance ratio	approx chi pr
Cut-point 0/1		-0.04	1.24	-	0.972			
Cut-point 1/2		2.84	1.26	2.26	0.024			
TK4	1	0.2032	0.0873	2.33	0.020*	21.155	21.16	<.001***
AP4	1	-0.2072	0.0817	-	0.011*	5.153	5.15	0.023*
AP2	1	-0.0403	0.0194	-	0.037*	4.526	4.53	0.033*
A9	1			2.53		2.874	2.87	0.090^
A9 2		0.314	0.246	1.28	0.202			
TK6	1	0.1178	0.0863	1.36	0.173	1.736	1.74	0.188
A4	3					1.953	1.95	0.119
A4 2		-0.655	0.285	-	0.021*			
A4 3		-0.176	0.314	-	0.575			
A4 4		-0.670	0.555	-	0.227			
AP3	1	0.1092	0.0761	1.44	0.151	1.388	1.39	0.239
TS1	1	0.0552	0.0399	1.38	0.166	1.755	1.76	0.185
A2	1			1.21		1.644	1.64	0.200
A2 2		0.724	0.586	1.24	0.216			
Residual	303					1.756		
Total	314					1.841		

Significant level: *** $p < 0.001$, ** $p < 0.01$, * $p < 0.05$, ^ $p < 0.10$

Parameters for factors are differences compared with the reference level:

Factor	Reference level
A9 (Sector of Employment)	1 (Public Sector)
A4 (Age)	1 (21 -30 years)
A2 (Language Proficiency)	1 (Malay Language & English)

C The Effect of Financial Constraints on Compliance Behaviour

It appeared that financial constraints had little effect on individual taxpayers' compliance behaviour. This is to be expected given that the research found that financial constraints were not a main concern among individual taxpayers in Malaysia, particularly in respect of salary and wage earners. Further, with the relatively low tax rates imposed on individual taxpayers as compared to some other countries (such as those in Australia and New Zealand), coupled with relief and rebates available, it was apparent from the case study that individual taxpayers could be paying very minimal tax (or even having zero tax liability). Financial constraints were found to have more direct and strong influence on the compliance behaviour of Malaysian individual taxpayers who were self-employed (see Table 7). This finding provided clearer evidence that financial constraints did have different effects on different categories of taxpayers rather than on all taxpayers as a whole and is consistent with the literature.⁴⁰

⁴⁰ J Vogel, 'Taxation and Public Opinion in Sweden: An interpretation of Recent Survey Data' (1974) 27 *National Tax Journal* 499; K E Wärneryd and B Walerud, 'Taxes and Economic Behaviour: Some Interview Data on Tax Evasion in Sweden' (1982) 2 *Journal of Economic Psychology* 187; Clotfelter, above n 9; A D Witte and D F Woodbury, 'What We Know About the Factors Affecting Compliance With the Tax Laws' (1983) *Income Tax Compliance: A Report of the ABA Section of Taxation Invitational Conference on Income Tax Compliance Proceedings* 133; Witte and Woodbury, above n 9; J Alm, B.R. Jackson and M McKee, 'Estimating the Determinants of Taxpayer Compliance with Experimental Data' (1992) 45(1) *National Tax Journal* 107; J C Young 'Factors Associated With Non-Compliance: Evidence From the Michigan Tax Amnesty Program' (1994) 16(2) *Journal of American Taxation Association* 82; C Roy-Chowdhury, *Is the Tax System Too Complex?* (2003) BBC News <<http://www.newsvote.bbc.co.uk>> at 1 November 2004; R Mottiakanvandar, H Haron and J Kasipillai, "Level of Tax Compliance Among Small Business Entrepreneurs: An Examination of Their Demographic Profile" (2004), *Accountants Today* March, 34-37 and April 36-39.

Table 7: Factors associated with reporting of taxable income - self employed

Estimates of parameters and accumulated analysis of deviance

Parameter	d.f.	estimate	s.e.	t	t pr.	mean deviance	deviance ratio	approx chi pr
Cut-point 0/1		6.40	2.82		0.023			
Cut-point ½		9.73	2.93		<.001			
TS1	1	0.2453			<.001***	13.509	13.51	
KB4	1	0.437	0.0714	3.44	<.001***	8.892	8.89	<.001***
A2	1			3.62				
A2 2		1.805	0.914		0.048*			
A4	3			1.97				
A4 2		-0.902	0.569	-	0.113	2.319	2.32	0.073^
A4 3		0.523	0.687	-	0.447			
A4 4		-2.73	1.07	-	0.011*			
KB6	1	0.449	0.147		0.002**	3.308	3.31	0.069^
A11	5			3.04				
A11 2		-0.87	1.18	-	0.459	2.233	2.23	0.048*
A11 3		0.836	0.860		0.331			
A11 4		-1.493	0.685	-	0.029*			
A11 5		-1.446	0.821	-	0.078^			
A11 6		0.621	0.567		0.273			
TK5	1	0.474	0.146		0.001**	2.381	2.38	0.123
A5	3			3.25				
A5 2		-1.010	0.561	-	0.072^	2.275	2.28	0.078^
A5 3		-0.196	0.962	-	0.838			
A5 4		-10.8	19.3	-	0.576			
A6	3			0.56				
A6 2		-0.359	0.789	-	0.650	2.533	2.53	0.055^
A6 3		-2.003	0.689	-	0.004**			
				2.91				

Parameter	d.f.	estimate	s.e.	t	t pr.	mean deviance	deviance ratio	approx chi pr
A6 4		-1.73	1.07	-	0.107			
				1.61				
FC2	1	-0.409	0.203	-	0.044*	3.970	3.97	0.046*
				2.02				
KB7	1	0.335	0.205	-	0.102	4.129	4.13	0.042*
				1.63				
KB5	1	-0.169	0.103	-	0.100	2.616	2.62	0.106
				1.65				
AP2	1	-0.0360		-	0.236	2.485	2.48	0.115
			0.0303	1.19				
AS1	1	-0.1285		-	0.081^	2.103	2.10	0.147
			0.0737	1.74				
A14	4					1.726	1.73	0.141
A14 2		-0.34	1.60	-	0.832			
				0.21				
A14 3		1.12	1.56		0.470			
				0.72				
A14 4		0.68	1.60		0.674			
				0.42				
A14 5		2.42	2.32		0.298			
				1.04				
Residual						1.752		
	105							
Total						2.032		
	133							

Significant level: *** $p < 0.001$, ** $p < 0.01$, * $p < 0.05$, ^ $p < 0.10$

Parameters for factors are differences compared with the reference level:

Factor	Reference level
A2 (Language Proficiency)	1 (Malay Language & English)
A4 (Age)	1 (21 -30 years)
A11 (Types of Business)	1 (Trading)
A5 (Ethnicity)	1 (Malay)
A6 (Levels of Education)	1 (School)
A14 (Levels of Tax Knowledge Rated)	1 (Extremely Good)

D The Effect of Taxpayer Attitudes on Compliance Behaviour

In terms of attitudes towards tax, two findings emerged from the survey (see Table 5 above) and the case study. Taxpayers' attitudes, in terms of their confidence in handling their tax affairs, did have a positive impact on their behaviour. However, taxpayers' attitudes towards the tax system, the tax administration and the Inland Revenue Board of Malaysia's officers' roles, had a negative impact on their decision to comply. In this context, the findings of this research are consistent with other studies which have found that taxpayers with

more favourable attitudes towards the tax system would be more compliant.⁴¹ In contrast to the differential effect of financial constraints, these findings in respect of taxpayers' attitudes applied to individual taxpayers as a whole.

E Interaction between the Various Influences Affecting Compliance Behaviour

The outcomes of the mixed method study did provide evidence about the relationships between the five categories of causes and individual taxpayers' compliance behaviour. The statistical correlation analysis derived from the post self assessment survey data did indicate that although no strong relationships existed among the five categories of causes, there were nevertheless some relationships ranging from weak ($r=.10$ to $.29$ or $-.10$ to $-.29$) to moderate ($r=.30$ to $.49$ or $-.30$ to $-.49$). The correlation results (see Table 8) showed that attitude towards tax was significantly and negatively correlated with financial constraints and tax knowledge, but significantly and positively correlated with the assessment system. In addition, tax knowledge had highly significant positive correlation with tax structure features. The relationship between these two causes (that is, tax knowledge and tax structure features) was further evidenced by the interactive effects arising from the outcomes of the experiment in which participants showed improvement in their reporting compliance when tax structure features (particularly audit and penalty) interacted with tax knowledge.

Table 8: Correlation of factors and moderating variables

		AS	AP	TS	FC	TK
Assessment system	AS	1				
Attitudes towards tax	AP	.108*	1			
Tax structure features	TS	.088	-.042	1		
Financial constraints	FC	-.086	-.121**	.004	1	
Tax knowledge	TK	.019	-.331***	.258***	-.079	1
Gender	A1	.088	.001	.046	.058	-.022
Language proficiency	A2	-.046	-.032	-.045	-.075	.054
Age	A4	.019	.066	-.013	.038	-.086
Ethnicity	A5	-.006	-.002	.014	-.181**	.058
Level of education	A6	-.051	.088	-.011	-.111*	-.043
Category	A8	.039	-.059	.025	-.117*	.087
Level of tax knowledge rated	A14	.024	-.271***	.146**	.049	.173***

* significant at 0.05 level ** significant at 0.01 level *** significant at 0.001 level

The results of this research also revealed that, in the case of individual taxpayers in Malaysia, the imposition of tax structure features (namely audit and penalty) would have a positive impact on their attitudes and responsibilities towards tax and on their tax knowledge. It is implied that as a result of the introduction of self assessment, taxpayers would assume more responsibilities for their own tax affairs in order to avoid being penalised for failure to file tax returns or for the filing of erroneous tax returns. To discharge these responsibilities, taxpayers would try to acquire more or improve their tax knowledge. As a result of the improvement in their tax knowledge, their attitudes towards tax in terms of

⁴¹ Chan, Troutman and O'Bryan, above n 7; V U Trivedi, M Shehata and S Mestelman 'Attitudes, Incentives Tax Compliance' (2005) 53(1) *Canadian Tax Journal* 29.

confidence in handling their own tax affairs would eventually show positive improvement.

Further, the participants in the experiment also showed improvement in reporting compliance after having acquired better tax knowledge. In this context, the Malaysian individual taxpayers' compliance behaviour is consistent with the contention of the general economic deterrence theory, that taxpayers would weigh the costs and benefits before making any decision as to whether or not to comply.

However, the findings of this research (from survey and case study) did reveal that increases in taxpayers' tax knowledge would have a negative impact on some taxpayers' attitudes towards the tax administration and on their perceptions of the Inland Revenue Board of Malaysia officers' roles as well as on their perceptions of the fairness of the tax system. This is further evidenced by the respondents' self-rated level of tax knowledge which was found to have a significant negative ($r=-.271$) relationship with their attitudes towards tax. Survey respondents with higher self-rated levels of tax knowledge did exhibit better tax knowledge, but the negative correlation also indicated significant negative impact on their attitudes towards tax. In this respect, enhancement of tax knowledge did not necessarily enhance some respondents' attitudes towards taxation.

This aspect of the research findings appeared to contradict the general contention of some other studies which found that having better tax knowledge would improve a taxpayer's attitude towards taxation.⁴² However, a study by Tan and Chan⁴³ found that increased tax knowledge did not have significant impact on the perceptions of fairness and tax compliance attitudes.

In terms of taxpayers' perceptions on the change of assessment system, a negative impact on their attitudes towards tax was shown in the post self assessment survey and in the case study. The reasons for this negative impact were due firstly to the insufficient publicity on the operations of the new self assessment system; and secondly, to the insufficient tax education provided before the actual implementation of self assessment. As a result, individual taxpayers were not ready for the new assessment system and most were of the opinion that the Inland Revenue Board of Malaysia was transferring its responsibilities to the taxpayers. This negative impact could also be linked to the level of moral reasoning among some of the individual taxpayers in Malaysia. Previous studies have found that having higher levels of moral reasoning would have positive impacts on individuals' compliance behaviour.⁴⁴

Taxpayers who encountered greater financial constraints had more negative attitudes towards tax. Ethnicity, level of education and taxpayer type were found to have significant relationships with financial constraints. Presumably, those with more family commitments and those who engaged the services of tax agents to file their returns would not seek to enhance their attitudes towards the tax administration.⁴⁵

⁴² Song and Yarbrough, above n 17; Lewis, above n 5; Eriksen and Fallan, above n 18; Trivedi Shehata and Mestelman, above n 38.

⁴³ L M Tan and C F Chan, 'The Impact of Tax Knowledge on the Perceptions of Tax Fairness and Attitudes Towards Compliance' (2000) 8(1) *Asian Review of Accounting* 44.

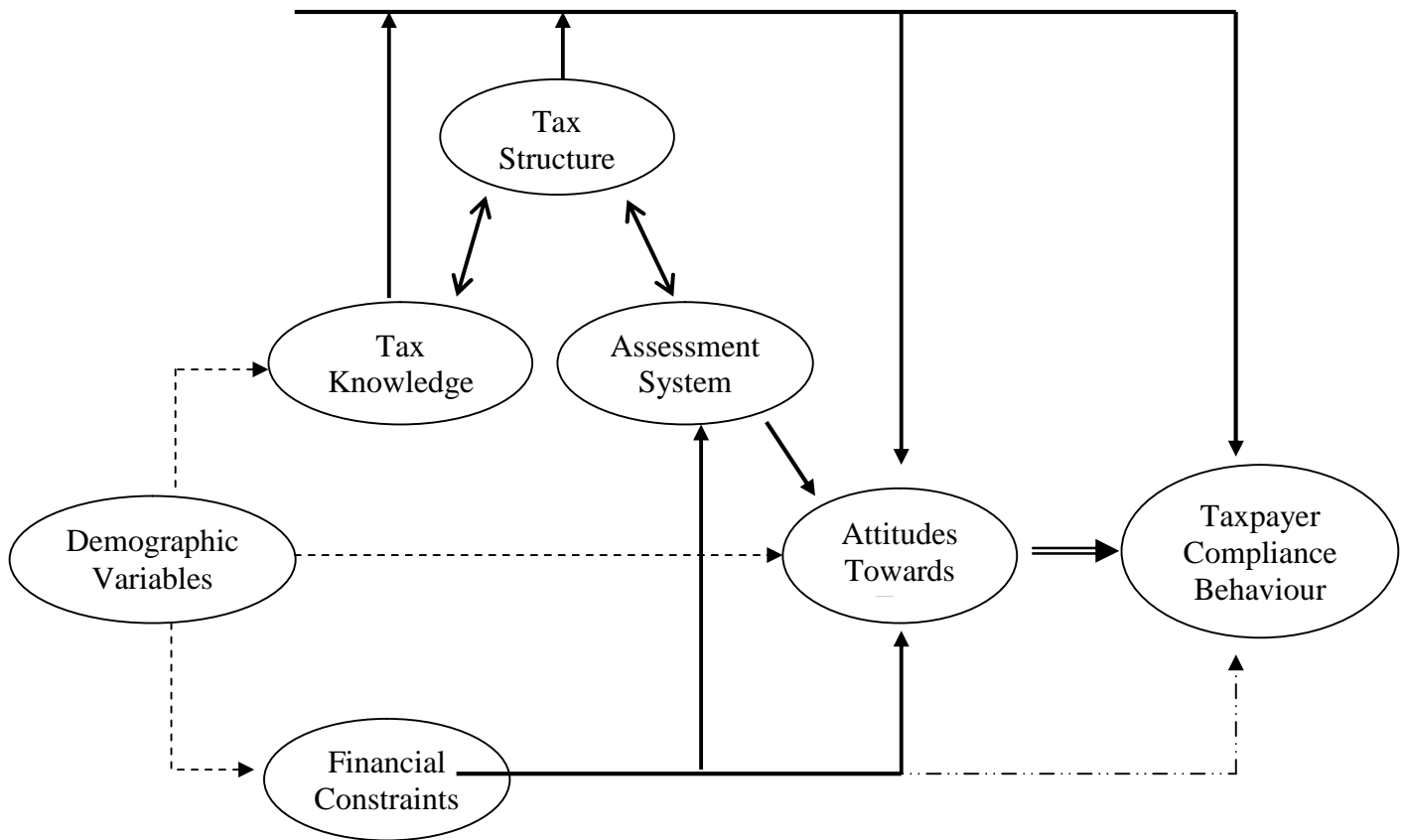
⁴⁴ B Erard and J S Feinstein 'Honesty and Evasion in the Tax Compliance Game' (1994) 25(1) *Rand Journal of Economics* 1; Chan, Troutman and O'Bryan, above n 7.

⁴⁵ R B Cialdini, 'Social Motivations to Comply: Norms, Values and Principles' in J A Roth and J T Scholz (eds), *Taxpayer Compliance: Social Perspectives* (1989), 202; Klepper and Nagin, above

Based on the above findings, the relationships between the five causes and the demographic variables in the context of the Malaysian individual taxpayers' compliance behaviour are presented in the model at Figure 1 from which it is apparent that the assessment system was found to be closely linked to tax structure features. The implication is that the change in assessment system would affect the tax structure features (for instance, change in the enforcement activities such as tax audit and penalty) which would then affect the compliance behaviour of individual taxpayers. The imposition of tax audit and penalty also directly affected taxpayers' compliance behaviour. In addition, both the assessment system and the tax structure features impacted on taxpayers' attitude towards tax. That is, the change of assessment system (from official assessment system to self assessment) coupled with tax audits and the imposition of penalties affected taxpayers' attitudes towards tax, which in turn affected their compliance behaviour. However, the relationship of the two causes (i.e. assessment system and tax structure features) collectively did not affect the financial constraints of individual taxpayers in Malaysia. Instead, financial constraints were found to be both mediated by the demographic variables and correlated with the taxpayers' attitudes towards tax, as well as directly affecting taxpayers' compliance behaviour. Thus, it could be concluded that the level of taxpayers' education (particularly in the case of salary and wage earners) affected their choice of occupation and, as a consequence, their level of income and ultimately their financial position.

n 8; R B Cialdini and N J Goldstein, 'Social Influence: Compliance and Conformity' (2004) 55 *Annual Review of Psychology* 591.

Figure 1: A general model of personal income tax compliance behaviour



Note:

- - - - - indicate effect/influence for the self-employed only
- ==== indicate effect/influence for the salary and wage earners only
- indicate effect/influence for both self-employed and the salary and wage earners
- - - - - indicate mediating effect for both salary and wage earners and self-employed

It has been shown that taxpayers' tax knowledge has a direct effect on their compliance behaviour. The relationship between tax knowledge and tax structure features suggests that tax enforcement activities indirectly 'forced' taxpayers to acquire more tax knowledge in order to comply. Taxpayers' financial constraints also affected their tax knowledge in relation to understanding of relief and rebates available. In addition, taxpayers' tax knowledge was mediated by their demographic variables. For instance, the level of education affected the level of tax knowledge that the individual acquired. This in turn was affecting their attitudes towards tax and eventually affecting their compliance behaviour (especially in the case of salary and wage earners).

Of the five categories of causes, tax knowledge emerged as the most effect in determining individual taxpayers' compliance behaviour. Hence, the major impact of the introduction of self assessment was its contribution towards improvement in the level of tax knowledge that taxpayers possessed. As a result

of the introduction of self assessment, in order to discharge their tax obligations, taxpayers needed to have reasonably adequate tax knowledge at least to enable them to fill in their tax returns and to be able to compute with reasonable accuracy their tax liabilities. The tax knowledge that taxpayers acquired would also enable them to understand the chargeability of specific income as well as knowing the deductibility of specific expenses incurred. This appeared to be critical as taxpayers' tax knowledge could affect their attitude especially in terms of confidence in handling their tax affairs, which eventually would affect their compliance behaviour. Hence, any lack of tax knowledge on understanding of the chargeability of any income and deductibility of any expense would eventually lead to unintentional non-compliance or over compliance.

In the context of the multi-ethnic Malaysian society, this research has provided further insights into the differing needs of the different ethnic groups in relation to the language of communication and the language of (and need for) tax education programmes. Further, this research has provided insights into taxpayers' attitudes towards taxation and how different taxpayers deal with their tax affairs.

V CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

In summary, of the five categories of causes, tax knowledge emerged as the most effect in determining individual taxpayers' compliance behaviour. Hence, the major impact of the introduction of self assessment was its contribution towards improvement in the level of tax knowledge that taxpayers possessed. Further, tax knowledge could affect taxpayers' attitudes to taxation, especially in terms of their confidence in handling their tax affairs, which eventually would affect their compliance behaviour. Tax structure features were found to have reasonably strong effect on individual taxpayers' compliance. The other three categories of causes (*viz.* the assessment system, attitudes toward tax and financial constraints) to some extent were also found to have affected individual taxpayers' compliance behaviour. Finally, only two of the five causes (*viz.* attitude towards tax and financial constraints) showed significant differences in affecting compliance behaviour of the self-employed and salary and wage earners individual taxpayers in Malaysia. Attitude towards tax did affect the compliance behaviour of the salary and wage earners but not that of the self-employed. However financial constraints did affect the compliance behaviour of the self-employed but not that of the salary and wage earners.

It is acknowledged that one of the limitations of this research is its focus on only five categories of causes. A further two categories of causes (*viz.* taxpayers' political preferences and taxpayers' accounting knowledge, particularly in relation to the preparation of financial statements by the self-employed) were found in the case study and it is acknowledged that others may well exist.

Other limitations of this research are those mainly and inherently found in the use of quantitative methodology. In respect of the survey methodology, it is acknowledged that the reliability of self-reporting of attitudes and behaviour is questionable, especially given that information in the context of taxation may be

sensitive, potentially incriminating or embarrassing.⁴⁶ Further, the survey results may have been affected by non-response bias in spite of the efforts made to minimise it.

In respect of the experiment, it is recognised that artificial game situations might not be representative of actual situations.⁴⁷ However, the fact that the experiment reflected real world settings does enhance its generalisability.⁴⁸ Another limitation to consider is the extent to which experimental results based on student participants can be generalised more broadly. However, Alm and Jacobson⁴⁹ argue that there is no reason to believe that the cognitive processes of students are different to those of 'real' people. Further, they state that there is now much evidence that the experimental responses of students are seldom different than the responses of other subject pools.

Finally, this research was conducted using a cross-sectional study. Perhaps future research could be conducted via a longitudinal study. A longitudinal study would allow researchers to investigate the causes/factors that contribute to changes in individual taxpayers' compliance behaviour over time. For instance, studies could explore the pattern of changes in terms of taxpayers' financial commitments and how compliance costs affect compliance behaviour. A longitudinal study could also be directed at studying taxpayers' level of tax knowledge over time. It may be that taxpayers' level of knowledge declines after the introduction of self assessment if they believe that they have a satisfactory understanding of its requirements. If unaddressed, this could result in habitual unintentional noncompliance over time, and this in turn could have serious consequences for the level of voluntary compliance achieved by the Inland Revenue Board of Malaysia.

Given the complexity and diversity of human behaviour, understanding tax compliance behaviour remains a challenging task for both revenue authorities and researchers. Collaboration and co-operation between revenue authorities and researchers is paramount if a deeper understanding of taxpayer compliance behaviour is to be achieved. This understanding will allow the revenue authority to better predict outcomes and to more effectively plan and implement the required strategies to achieve its objectives in respect of maximising voluntary compliance. This mixed method study has shown that these strategies should include educating taxpayers (particularly when major changes are made, such as the introduction of self assessment) and fostering a positive attitude in taxpayers towards both taxation and the tax authority.

⁴⁶ D J Hessing, H Elffers and R H Weigel, 'Exploring the Limits of Self-Reported and Reasoned Action: An Investigation of the Psychology of Tax Evasion Behaviour' (1988) 54 *Journal of Personality and Social Psychology* 405.

⁴⁷ J Alm 'A Perspective on the Experimental Analysis of Taxpayer Reporting' (1991) 66(3) *Accounting Review* 577; B C Martindale, B S Koch and S S Karlinsky, 'Tax Law Complexity: The Impact of Style' (1992) 29(4) *Journal of Business Communication* 383.

⁴⁸ Fischer, Wartick and Mark, above n 6.

⁴⁹ J Alm and S Jacobson, 'Using Laboratory Experiments in Public Economics' (2007) LX(1) *National Tax Journal* 129.

IS THE COMMISSIONER RIGHT TO NOT SEEK SPECIAL LEAVE OF THE HIGH COURT TO APPEAL AGAINST THE FULL FEDERAL COURT'S DECISION IN MURDOCH?

MAHESWARAN SRIDARAN*

The Commissioner did not seek special leave of the High Court to appeal against the Full Federal Court's decision in Murdoch v Commissioner of Taxation. This article argues that the Commissioner must have sought such special leave. The taxpayer (Dame Elisabeth Murdoch) was a life tenant of certain trusts, and was the sole income beneficiary of those trusts. Her son, Mr Rupert Murdoch, was the sole remainderman of those trusts. The principal assets of those trusts were shares in Cruden Investments Pty Ltd, a company which owned shares in companies of the News Group. Mr Rupert Murdoch was, at all times, the chief executive officer of companies of the News group. The taxpayer contended that, if those trusts' investments had been more 'balanced', she would have been entitled to greater income by way of periodic distributions from those trusts, as the current investment policy of those trusts resulted in greater capital growth of the assets of those trusts (not greater growth in the income of those trusts), which accrued to the exclusive benefit of the remainderman (and not the taxpayer). She, accordingly, claimed from the trustees of those trusts (which included Mr Rupert Murdoch) and the remainderman compensation to remedy that deficiency. The trustees of those trusts and the remainderman did not accept that claim, but reached a compromise under which the taxpayer was paid compensation, in a single lump sum, by those trusts of some \$85 million. Those trusts raised that amount through proceeds of an equal amount from a court-approved reduction of share capital by Cruden Investments Pty Ltd encompassing the shares in that company owned by those trusts. The Commissioner assessed the taxpayer to income tax on that lump sum on the basis that it was her income. The taxpayer appealed against that assessment to the Administrative Appeals Tribunal, which held for the Commissioner. The taxpayer appealed that holding to the Full Federal Court, which unanimously overturned it. The decision of the Full Federal Court was that the lump sum received by the taxpayer was a capital gain (and not income). That was so because, the Full Federal Court seems to have reasoned that the taxpayer's claim was for an accounting by the remainderman to the taxpayer of an actual capital gain made by the remainderman and held by the remainderman under a constructive trust for the benefit of the taxpayer. This article argues that the Full Federal Court erred in holding so, as it failed to draw the proper conclusion upon applying the relevant law to the facts.

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I INTRODUCTION

This article considers the developments in the *Murdoch* case¹ where, in particular, the Commissioner did not seek special leave of the High Court to appeal against the Full Federal Court's decision in *Murdoch v Commissioner of Taxation* ('*Murdoch*').² This article argues that the Commissioner should have sought such special leave.

II FACTS

The facts set out below are as ascertained from the decisions of the Administrative Appeals Tribunal ('the AAT') and the Full Federal Court. Where facts which were considered relevant could not be ascertained from those decisions, it has been stated so below.

A The terms of the trusts

The taxpayer was Dame Elisabeth Murdoch, wife of late Sir Keith Murdoch and mother of Mr Rupert Murdoch. In 1936 and 1937, Sir Keith established eight inter vivo trusts ('the trusts'), of which one or more of his eldest three children (including Mr Rupert Murdoch) or their children were remaindermen (remaindermen are those beneficiaries of a trust who are entitled to the assets of the trust upon the death of those beneficiaries of the trust who are life tenants). Of the trusts, the taxpayer was a life tenant, and, accordingly, for her life, either the sole income beneficiary or one of the income beneficiaries together with one or more of those children of Sir Keith. (A life tenant is a beneficiary of a trust who is entitled to benefit from the assets of the trust only while that beneficiary remains alive.)

The terms of the trusts as to the distribution of income were substantially similar. Those terms typically read:

The trustee shall hold the trust fund IN TRUST to pay the income arising therefrom to the wife for life for her own use and benefit absolutely and upon the death of the wife IN TRUST as to both the capital and income of the Trust Fund for the son conditionally upon his attaining the age of twenty-five years.

The trustee of the trusts, until 1983, was The Trustees Executors and Agency Company Ltd. In 1983, that company was replaced as trustee by the taxpayer, Mr Rupert Murdoch and Mr Jack Kennedy. In 1991, the taxpayer and Mr Jack Kennedy were replaced as trustees by Actraint No 119 Pty Ltd, whose shareholders and directors were the taxpayer and Mr Jack Kennedy.

On 8 November 1991, a Reorganisation Agreement was entered into between, among others, the taxpayer, Actraint No 119 Pty Ltd and Mr Rupert Murdoch. Under that agreement, the taxpayer surrendered her life interests in the trusts except for her life interests in four of those trusts in which Mr Rupert Murdoch was the sole remainderman (those four trusts are, in this article, referred

¹ *Murdoch v Commissioner of Taxation* [2008] FCAFC 86 (28 May 2008) ('*Murdoch*').

² Australian Taxation Office, *Decision Impact Statement: Murdoch v Commissioner of Taxation* (23 July 2008).

to as ‘the subject trusts’, as that is the expression used in the Full Federal Court’s decision to refer to them).

During the life of Sir Keith and since his death, the principal assets of the trusts were shares in Cruden Investments Pty Ltd, a company which owned shares in News Ltd until 1979, and, from then, in News Corporation Ltd, which became the ultimate parent of News Ltd. Mr Rupert Murdoch was, at all times, the chief executive officer of the two latter companies and all other companies of the News Group.

The terms of the trusts as to the trustees’ investment powers were substantially similar. Those terms typically read:

Any funds in the hands of the Trustees for investment shall during the life of the Settlor be invested in such securities bonds stocks debentures or other investments as the Settlor shall in his absolute discretion direct and the Trustees shall if and whenever so directed by the Settlor sell and dispose of or otherwise realize any particular securities bonds stocks shares debentures or other investments in which the Trust Fund or any part thereof is for the time being invested and shall for the purposes of any such realization if so directed by the Settlor take or join in taking any steps to wind up any company of or in which the Trustees hold stocks shares or debentures as part of the Trust Fund and from and after the death of the Settlor the Trustees shall either continue to hold any of then existing investments or at their discretion shall call in and convert the same into money and with the like discretion invest the money arising thereby or otherwise in their hands for investment in the names of the Trustees upon some one or more of the securities authorized by any Statute for the time being in force in any State of the Commonwealth of Australia authorizing the investment by Trustees of Trust Funds or upon the shares or debentures of any public industrial company which has been carrying on business in Australia for at least three years and which has paid up capital of not less than One hundred thousand pounds. During the life of the Settlor the Trustees shall not be entitled to call for a transfer into their own names of any of the property comprised in the said Trust Fund (whether as a result of investment or otherwise) which shall be in the name of the Settlor and such property shall unless the Settlor otherwise elects be left in his name.

B Advice of Mr D Heydon QC and Wyatt Company Pty Ltd), a firm of consulting actuaries

About April 1994, advice was sought from Mr D Heydon QC on whether the taxpayer has a valid claim against the trustees of the trusts due to the investment policy adopted by those trustees with respect to the trusts. That advice was sought by a solicitor who had acted for Mr Rupert Murdoch from the late 1970s to the late 1990s. It is not known whether that advice was sought (by that solicitor from Mr Heydon) on behalf of the taxpayer, Mr Rupert Murdoch, or both. That solicitor’s evidence included a memorandum he received from lawyers from overseas, which read:

If Dame Elisabeth has a valid claim under Australian Law with respect to the ‘Power to Contain Conversion’, because she was not receiving a fair

current return, Rupert would be obligated to act together with the other trustee and correct the situation by making a distribution to Dame Elisabeth. A distribution of this type made by the trustees to bring the trust into compliance with Australian law would not be construed to be a gift made by Rupert under United States law.³

Around the same time, advice was sought (it is not known by whom, and on whose behalf that advice was sought) from Wyatt Company Pty Ltd ('Wyatt'), a firm of consulting actuaries, to supplement the matter on which Mr Heydon's advice was sought. In June 1994, Mr Heydon provided the first of two written opinions ('the first opinion'). That opinion was based on instructions given to Mr Heydon to the effect:

- that the dividend yield of those companies in which the trusts held an interest through the trusts' ownership of shares in Cruden Investments Pty Ltd which were public companies had 'been very low relative to the earnings of blue chip shares in industrial companies quoted on the Stock Exchange, though there has been a considerable rise in the value of those shares';⁴ and
- that 'the result had been that Dame Elisabeth Murdoch has received much less income in virtue of her life interest than she would have done had the Trust Fund been differently invested'.⁵

In the first opinion, Mr Heydon addressed whether the taxpayer can sustain a claim on the authority of *Howe v Lord Dartmouth*⁶ and *Re Earl of Chesterfield's Trusts*,⁷ and concluded that she cannot. He then, in the first opinion, addressed whether the trustees of the trusts had breached their duty owed to the taxpayer (in her capacity as a life tenant of the trusts) by their failure to exercise the powers of investment conferred on them in a manner so as 'to hold the balance properly between capital and income'.⁸ With respect to that issue, Mr Heydon reached the following conclusion:

Whether the various trustees are liable for breach of trust to Dame Elisabeth Murdoch is thus a difficult question. If they were, the quantum of compensation for that breach may be hard to calculate but in principle it would be the difference between what the income of the assets could have been had they been invested in a mix of blue chip shares and other authorized investments producing a reasonable income, and what Dame Elisabeth actually received.⁹

He concluded that, if there had been such a breach of duty by the trustees, a court 'might recognize a charge over the remainder interests to benefit the tenant for life to the extent to which she was disadvantaged',¹⁰ and:

Alternatively, on the reasoning in paragraph 254 [of Scott on Trusts (4th edition)], a court might hold that there was a constructive trust which could be vindicated by a sale of the property subject to the constructive

³ *Murdoch and Commissioner of Taxation* [2007] AATA 1791 (21 September 2007) ('*Murdoch*'), para 13.

⁴ *Murdoch* [2007] AATA 1791, para 14.

⁵ Above n 4, para 14.

⁶ (1802) 7 Ves 137.

⁷ (1883) 24 Ch D 643.

⁸ *Murdoch* [2007] AATA 1791, para 14.

⁹ Above n 8, para 14.

¹⁰ Above n 8, para 14.

trust (or, on the earlier analysis, subject to the charge): the proceeds of the sale could then be applied partly to compensate the tenant for life for past losses and thereafter reinvested on more appropriate securities.¹¹

If the facts, on investigation, turned out to be of the type indicated above there would be good prospects that the breach of duty by the trustees, and by Mr Murdoch as beneficiary-trustee in particular, could lead to the remedy indicated—a Court-ordered sale of the shares with a view first to compensating Dame Elisabeth Murdoch for past breaches, and then reinvestment of the fund in appropriate assets so as to achieve for the future a proper balance between the interests of those interested in income and those interested in capital.¹²

The instructions upon which the first opinion was based, it later transpired, were deficient as the distributions of income received by the taxpayer from the trusts were ‘well in excess of the gross income [which] could have been received had a “typical” investment policy been applied’. That was so as accretion (due to bonus issues of shares or otherwise) to the quantity of shares in those companies in which the trusts held an interest through the trusts’ ownership of shares in Cruden Investments Pty Ltd did cause the absolute amount of dividends received in respect of those shares to substantially increase, though the dividend yield of those shares was relatively low. Accordingly, Mr Heydon was requested to provide a second written opinion.

In the meantime, in July 1994, Wyatt provided a report which concluded: ‘[I]n all periods the accumulated value of the actual gross income received from [the trusts] is well in excess of the gross income we estimate could have been received had a ‘typical’ investment policy been applied since mid 1952 instead of the actual investment policy.’ It reached that conclusion because, over those periods, though the dividend yield of shares in companies of the News group had been relatively low, the absolute amount of dividends received by a shareholder who owned a quantity of those shares as at the beginning of those periods had substantially increased due to an accretion (as a result of bonus issues of shares or otherwise) to that quantity of shares owned.

In October 1994, Wyatt provided a further report which dealt with only the subject trusts. That report concluded that, as at certain dates specified in it, in the subject trusts, the value of the taxpayer’s interests (as the life tenant) was significantly less than the value of Mr Rupert Murdoch’s interests (as the remainderman) due to the investment policy followed by the trustees of those trusts not being ‘typical’.

In October 1994, Mr Heydon provided a second written opinion (‘the second opinion’). In it, he advised (reproduced below exactly as set out in the Full Federal Court’s decision, except the interpolations in italics):

- (a) ‘the disparity now appearing between the relative position of the income beneficiary under the actual [investment] policy and the relative position of the income beneficiary under the notional [investment] policy, if it resulted wholly or partly from breaches of trust by the trustees, can be described as analogous to overpayment of one beneficiary at the expense of another within the principles discussed on pages 20-21 of [the first opinion]’;

¹¹ *Murdoch* [2007] AATA 1791, para 14.

¹² Above n 11.

- (b) the problem referred to in para (a) 'is also a problem which may be the result of the trustee/remainderman having had goals which made investment policy adopted desirable, and having persuaded the other trustees (at least since 1983 and perhaps earlier) of the merits of that policy, or not having intervened with them to change it;
- (c) if the evidence in contested litigation supported this view, the principles discussed on pages 22-23 of the first opinion 'may operate not merely to permit an action for breach of trust against the trustees, but to create a charge in the nature of a constructive trust over the interest of the remainderman in the capital, being a charge capable of being enforced by sale';
- (d) there was 'a real possibility that the adoption of the [investment] policy was at various points a breach of trust induced by the remainderman' with the consequence that it would need to be 'accounted for by him and held by him in trust for the other beneficiaries, even though the gain could not have been made by lawful means, and even though the conduct in question has caused the other beneficiaries to be better off than they otherwise would have been: *Phipps v Boardman* [1967] 2 AC 46';
- (e) the analysis in the Wyatt Report 'shows that the gain made by the trustee/remainderman is, on his assumptions, \$193m for the first two [subject trusts] and \$83m for the other two;
- (f) in the circumstances it would not be unreasonable for the applicant [*that is, the taxpayer*] to seek to settle the potential dispute in relation to the subject trusts on terms involving the payment to the applicant of \$85 million or a transfer of assets of that value in consideration for her giving a release of all claims against the trustee/remainderman for the past breaches of trust and consenting to the maintenance by the trustees of the current investment policy.

The taxpayer was advised (presumably, by the solicitor who instructed Mr Heydon), on the basis of the second opinion (of Mr Heydon) and the report by Wyatt (presumably, of October 1994), she was entitled to make a claim on the capital of those trusts. That advice to her, however, did not state that she had 'any right to claim for loss of income'. Moreover, the taxpayer 'did not believe that any decision of the trustees caused [her] to lose income'. The taxpayer and the entities that had been the trustees of the subject trusts (Mr Rupert Murdoch, Mr Jack Kennedy and Actraint No 119 Pty Ltd) entered into a Deed of Release and Agreement ('the settlement deed') on 28 November 1994.

C The settlement deed

The settlement deed did contain the following recitals:

- I. The trustees of the Trusts from time to time since the death of the Settlor have followed an investment policy of investing the funds the subject of the Trusts almost exclusively in shares in companies, Cruden Investments Pty Ltd ('Cruden Investments') and Cruden Holdings Pty Ltd, which are not authorized trustee investments under Australian legislation relating to trustees (such investment policy being referred to below as the 'Investment Policy').

- J. Dame Elisabeth has claimed that:
- (i) the pursuit of the Investment Policy by the trustees of the Trusts:
 - has not given rise to any exceptional increase in income of the Trusts but has greatly increased the value of the corpus of the Trusts; and
 - involved significant risk for the beneficiaries of the Trusts, which risk was not properly rewarded in the case of Dame Elisabeth to the extent she only had an income interest under the Trusts;
 - (ii) in pursuing the Investment Policy, the trustees of the Trusts from time to time have since the death of the Settlor breached their trust duties to Dame Elisabeth as a life tenant;
 - (iii) Mr Murdoch, a man generally regarded as being of outstanding ability and force of personality with an extraordinary record of business success, as a trustee of the Trusts and the holder of the whole of the remainder interests in the Subject Trusts, had substantial responsibility for such breaches of trust since May 1983 because he was pursuing goals not properly goals of the Trusts, but which goals required the Investment Policy to be pursued and inter alia had the effect of improving Mr Murdoch's financial position as beneficiary in remainder under the Subject Trusts; and
 - (iv) that in the premises, a constructive trust has arisen in respect of eighty percent or more of the beneficial interest in the assets of the Subject Trusts, constituting the advantage to Mr Murdoch of the Investment Policy having been pursued in lieu of a more appropriate investment policy, and/or Dame Elisabeth has the benefit of a charge over the assets of the Subject Trusts which Dame Elisabeth is not entitled to be paid as income of the Subject Trusts accompanied by a right to have sufficient of the corpus of the Subject Trusts sold to compensate Dame Elisabeth for the breach of trust and/or to ensure the benefit of such advantage is made over to her and does not flow to Mr Murdoch.
- K. The Current Trustees (including Mr Murdoch) and Mr Kennedy do not, and Mr Murdoch as beneficiary in remainder under the Subject Trusts does not, admit any such breach of trust or the existence of any such constructive trust, or charge, or right of sale. With a view to avoiding unnecessary disputation and any need for litigation, however, the Current Trustees (including Mr Murdoch) and Mr Murdoch as such beneficiary in remainder are desirous of compromising the claims made by Dame Elisabeth.
- L. It has therefore been agreed that Dame Elisabeth, as the life tenant under the Subject Trusts, having shared in the risk of investing in the investments of the Subject Trusts, and in consideration of her releasing:
- (i) The Current Trustees and the former trustees under the Trusts from any claims by her against them for breach of trust or

otherwise in relation to following the Investment Policy in relation to the investments of the funds of the Subject Trusts and of the other of the Trusts; and

- (ii) The assets of the Subject Trusts and the other of the Trusts (being assets which Dame Elisabeth is not entitled to be paid as income of the Trusts) from any claims Dame Elisabeth has or may have upon or in respect of them other than her right to be paid a proportion of the undistributed current income and the future income of the Subject Trusts and any interest she may have in the capital and income of the other of the Trusts,

should be entitled to the following:

- (iii) that the ordinary shares in Cruden Investments ('the Cruden Investments shares') comprising the assets of the Subject Trusts should be in whole or in part realized (by way of sale of some of such shares or partial return of capital on all of such shares) to raise \$85,087, 176 in Australian currency; and
- (iv) that the \$85,087,176 be paid to Dame Elisabeth or as she may direct as the absolute property of Dame Elisabeth to deal with as she in a her full and complete discretion may determine.

The settlement deed did contain the following operative provisions:

2 LIFE TENANT RELEASES, AUTHORITIES AND REQUESTS

2.1 Subject to the other provisions of this deed, Dame Elisabeth, in her capacity as the Life Tenant, hereby releases and discharges each other party hereto from any claims, proceedings, obligations to account and other liabilities for or in relation to (including without limitation any loss arising to or profit of or other benefit to any other party hereto in respect of) any or all of the following which, had this deed not been entered into, such party would have had against such other party as the case may be:

- (a) the pursuit of the Investment Policy in relation to the investment of the funds of the Trusts and the failure of the Trustees at any time and from time to time to consider pursuing another policy or otherwise to realize, convert and reinvest the funds of the subject of the Trusts or to consider doing so;
- (b) any breach by the Trustees of the duties owed by the Trustees to the beneficiaries under the Trusts;
- (c) any right of action, whether at law or in equity, Dame Elisabeth has or may have against Mr Murdoch as a beneficiary of any of the Trusts in relation to any of above; and
- (d) any right of action Dame Elisabeth has or may have upon or in respect of Trust assets other than her right to be paid a proportion of the undistributed current income and the future income of the Subject Trusts and any interest she has or may have in the corpus or income of the other of the Trusts according to the express terms of the documents creating or recording the terms of the Trust.

2.2 Dame Elisabeth hereby authorizes and requests the Trustees to continue to carry on the Investment Policy and undertakes not to bring any claims or proceedings against any of the Trustees in respect thereof.

3 TRUSTEE UNDERTAKINGS

The Current Trustees hereby undertake:

- (a) promptly to raise the Settlement Amount by selling some of the Cruden Investments shares or participating in a reduction and return of capital by Cruden Investments on and in respect the Cruden Investments Shares; and
- (b) to pay to Dame Elisabeth the Settlement Sum on the Settlement Date.

4 REMAINDERMAN REQUEST AND AUTHORITY

Mr Murdoch, as the beneficiary in remainder under the Subject Trusts, requests and authorizes the Current Trustees to observe and perform their undertakings in clause 3 hereof.

In the settlement deed, the expression 'Settlement Sum', as referred to in clause 3 (b) reproduced above, was defined to mean \$85,087,186 in Australian currency.

D Consequences of entry into the settlement deed

On 28 November 1994, which was the date the settlement deed was entered into, in terms of that deed, the taxpayer was paid, as a lump sum, \$85,087,176 ('lump sum settlement') by cheque. That payment was made by the trustees of the subject trusts.

On the same date on which that payment was made to the taxpayer, she transferred approximately a third of which she so received to a trust that was associated with her. That trust used some of the money so received by it to make gifts to family members and charity, and it converted the remainder of that money to foreign currency 'for the purpose of making a gift to Mr K R Murdoch'. It was contemplated in the settlement deed that the payment of the lump sum settlement was to be met by the trustees of the subject trusts realizing those trusts' shares in Cruden Investments Pty Ltd. The trustees of the subject trusts met that payment through proceeds of an equal amount from a court-approved reduction of share capital by Cruden Investments Pty Ltd. The shares in that company owned by the trustees of the subject trusts which were encompassed by that capital reduction had been acquired by them before 20 September 1985.

The Commissioner assessed the taxpayer to income tax, for the year ended 30 June 1995, on the basis that the lump settlement received by her either was income of hers or was otherwise assessable income hers because it was a capital gain. The taxpayer appealed against that assessment to the AAT, which held that the lump settlement received by her was income of hers. Given that holding, the AAT did not consider the Commissioner's alternative contention that the lump sum settlement received by the taxpayer was otherwise assessable income of hers because it was a capital gain (but not a distribution of capital to the taxpayer representing a capital gain that must be ignored because it arose from the happening of CGT events A1 or C2 to CGT assets acquired by the trusts before 20 September 1985).

The taxpayer appealed that decision of the AAT to the Full Federal Court, which unanimously overturned that decision, holding that the lump settlement received by the taxpayer was not her income. Before the Full Federal Court, the Commissioner did not press his alternative contention that the lump sum settlement received by the taxpayer was otherwise assessable income to her because it was a capital gain (but not a distribution of capital to the taxpayer

representing a capital gain that must be ignored because it arose from the happening of CGT events A1 or C2 to CGT assets acquired by the trusts before 20 September 1985).

III THE LEGISLATIVE PROVISIONS RELEVANT TO *MURDOCH*

The legislative provisions relevant to imposing income tax on trusts and beneficiaries of trusts are contained in Division 6 of Part III of the *Income Tax Assessment Act 1936* (Cth). So far as relevant to *Murdoch*, essentially, the effect of those legislative provisions was as follows.

A trust must, for each income year, determine its “net income”, which is equal to the total assessable income (including capital gains which are not ignored for purposes of income tax) of the trust minus the total of allowable deductions, as if the trustee of the trust were a taxpayer.¹³ Where, for an income year, a beneficiary of a trust was “presently entitled” to a share of the net income of the trust, the assessable income of the beneficiary will include that share of net income, on which, therefore, income tax will be payable by the beneficiary, and not the trustee of the trust.¹⁴

If, for an income year, a beneficiary of a trust was not “presently entitled” to a share of the net income of the trust, with respect to that share of net income, income tax will be payable by the trustee of the trust, and not any beneficiary of the trust.¹⁵ To be “presently entitled” to a share of net income of the trust, as held by the High Court in a number of cases, the beneficiary must have an indefeasible, absolutely vested, beneficial interest in possession in that share of net income, and that share of net income must be legally available for distribution to the beneficiary by the trust.¹⁶ The character of the net income of a trust to which a beneficiary of that trust is “presently entitled” is the same character that net income had when it was derived by the trust.¹⁷

Accordingly, if a trust made a capital gain which is ignored for purposes of income tax (such as, say, a capital gain made from the happening of CGT event A1 or CGT event C2 to assets acquired by the trust before 20 September 1985), and if, in the income year in which that capital gain is made, a beneficiary of the trust becomes “presently entitled” to that capital gain, it will remain a capital gain that is ignored for purposes of income tax in the hands of that beneficiary. As outlined earlier, in *Murdoch*, at the Full Federal Court, it was not contended by the taxpayer that the lump sum received by her was a capital gain that is ignored for purposes of income tax, nor did the Commissioner contend that lump sum was a capital gain that was not ignored for purposes of income tax, which was thus assessable income of the taxpayer.

In *Murdoch*, at the Full Federal Court, it was not contended by the Commissioner or the taxpayer that the lump sum received by the taxpayer from the trusts was a distribution by the trusts to the taxpayer of “net income” of the

¹³ *Income Tax Assessment Act 1936* (Cth) s 95 (1).

¹⁴ *Income Tax Assessment Act 1936* (Cth) s 97.

¹⁵ *Income Tax Assessment Act 1936* (Cth) ss 99 and 99A.

¹⁶ *FC of T v Whiting* (1943) 68 CLR 199; *Taylor & another v FC of T* (1970) 70 ATC 4026; *Union Fidelity Trustee Co of Australia & another v FC of T* (1969) 69 ATC 4084; *Taxation Ruling IT 2622*.

¹⁷ *Charles v FC of T* (1954) 90 CLR 598.

trusts. Accordingly, whether the taxpayer was “presently entitled” to the lump sum in question did not become germane, though, clearly, that lump sum did not remain receivable, but rather had been received, by the taxpayer.

Murdoch did not turn on the proper interpretation of any of the legislative provisions canvassed above, as there was no controversy over their application. Rather, *Murdoch* turned on a most basic issue which the common law has grappled with on innumerable occasions, time and time again: that is, whether a lump sum received by a taxpayer is, in her hands, income or capital. Reaching the correct answer to that issue required the proper application of judicial principle, as gleaned from case law, to the facts of the case.

IV FULL FEDERAL COURT’S ANALYSIS

The decision of the Full Federal Court, in *Murdoch*, was a unanimous one, which held that the lump sum settlement of \$85,087,176 received by the taxpayer was not her assessable income. The essential reasons as to why it held so are contained in the following two paragraphs of its judgment:

It is common ground that where a taxpayer provides consideration in the form of a release of a claim, the consideration, that is to say, the release ‘will ordinarily supply the touchstone for ascertaining whether the receipt is on revenue account or not’: *Federal Coke Co Pty Ltd v Federal Commissioner of Taxation* (1977) 15 ALR 449 at 472 per Brennan J; *Allied Mills Industries Pty Ltd v Federal Commissioner of Taxation* (1989) 20 FCR 288 at 309.¹⁸

[W]e do not think that the Lump Sum [that is, the lump sum settlement received by the taxpayer] was compensation for the release of a claimed entitlement to that which would have been assessable income: cf *Federal Commissioner of Taxation v Dixon* (1952) 86 CLR 540; *Federal Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199; *Federal Commissioner of Taxation v Rowe* (1997) 187 CLR 266 at 276.¹⁹

The point that the Full Federal Court makes in the first of those two paragraphs is unexceptionable. That point is whether the lump sum settlement received by the taxpayer is assessable income to her must be determined with reference to the substance of the release granted by her, as she received the lump sum settlement in return for granting that release. The point that it makes in the second of those two paragraphs, however, is not, which is an issue that, therefore, merits close scrutiny if one were to argue, as this article does, that the decision of the Full Federal Court, in *Murdoch*, was wrong.

What, then, was the substance of the release granted by the taxpayer? Given the point it made in the first of those two paragraphs, the Full Federal Court must have necessarily answered that question with close regard to the terms of the settlement deed. It, however, most remarkably, failed to do so, which was a fatal deficiency. The best that the Full Federal Court did, in that respect, is represented by the following passages in its judgment:

In *Phipps v Boardman*, the House of Lords applied a principle that it had recognized in *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 ... In summary, that line of authority is to the effect that a trustee or other

¹⁸ *Murdoch* [2008] FCAFC 86, para 12.

¹⁹ Above n 18, para 13.

fiduciary is accountable for a profit he or she made from a breach of fiduciary duty, even though the profit is one that the beneficiary to whom the trustee or other fiduciary is liable to account could not have made.²⁰

The rule recognized in *Phipps v Boardman* has been accepted as forming part of the law in Australia. ...²¹

In his second opinion, Mr Heydon QC thought the principle recognized in *Phipps v Boardman* was arguably applicable to the circumstances of Mr Murdoch's dealings with the trust estate. Mr Murdoch clearly stood in a fiduciary relationship to the applicant. If the applicant could prove the matters recited in paras (i), (ii) and (iii) of Recital J of the Settlement Deed, a *Phipps v Boardman* claim for an accounting would be made out.²²

...
The Commissioner relies on the reference to the applicant's status as Life Tenant in the Settlement Deed but we do not think this is to the point. That reference merely explains the basis of the existence of the fiduciary duty. What the applicant would have received would have been a sum representing the profit or gain made by Mr Murdoch, notwithstanding that she had no entitlement to it under the terms of the trust.²³

We say nothing about the likelihood of success of the claim that the applicant made: it is not disputed that she made it, and it is not disputed that it is the character of that claim and its notional fruits that determine whether the Lump Sum (being the consideration for release of that claim) was income derived by the applicant.²⁴

In our respectful opinion, the Tribunal erred in failing to characterize properly the character of the claim that the applicant gave up and, therefore, the character (income or not) of the Lump Sum that she received for giving it up. *The applicant's claim was to an accounting for a capital profit or gain made by Mr Murdoch and to an entitlement to a constructive trust over the assets of the trust estate, and she was paid the Lump Sum in satisfaction of those claims.* The Lump Sum was not income.²⁵ [emphasis added.]

If the Full Federal Court's decision is to be tenable, its conclusion in the penultimate sentence in the last of the paragraphs quoted just above, a sentence which has been highlighted in italics, must necessarily be supportable with reference to the terms of the settlement deed. It, however, cannot be, for the reasons canvassed below.

V WHY THE FULL FEDERAL COURT'S ANALYSIS IS NOT THE BEST

The Full Federal Court's analysis, and its decision, can be critiqued as not the best on the ground that the Full Federal Court erred in drawing the proper conclusion upon applying the relevant law to the facts. The AAT, as to the

²⁰ Above n 18, para 15.

²¹ Above n 18, para 23.

²² Above n 18, para 24.

²³ Above n 18, para 25.

²⁴ Above n 18, para 26.

²⁵ Above n 18, para 27.

question of what was the substance of the release granted by the taxpayer, concluded:

The types of claim or obligation specified in the release related to:

- 1 The investment policy and the trustees' failure to pursue another policy;
- 2 Breach of the trustees' duties to beneficiaries;
- 3 Rights of action as a beneficiary;
- 4 Rights of action in respect of assets other than the right to current and future income and any interest the taxpayer may have in corpus or income.

Categories 1 to 3 could only relate to the income paid to the taxpayer. Although category 4 contemplates rights in assets or corpus, the trust deed did not confer any such rights other than to secure her rights to income.²⁶

The claims enumerated as 1 to 4 in that passage exactly correspond to the claims enumerated as (a) to (d) in clause 2.1 of the settlement deed, a clause which has been quoted earlier. The conclusion reached by the AAT as to the effect of those claims, as noted in the last paragraph of that passage, is correct, and was decisive to the AAT's holding that the lump sum settlement received by the taxpayer was income of hers. Most surprisingly, the Full Federal Court did not analyse as to why that conclusion of the AAT was, in the view of the Full Federal Court, wrong. As will be evident from the passages of the judgment of the Full Federal Court quoted earlier, all that the Full Federal Court said in that respect was:

[i]n our respectful opinion, the Tribunal erred in failing to characterize properly the character of the claim that the applicant gave up and, therefore, the character (income or not) of the Lump Sum that she received for giving it up.²⁷

Soon after that statement, the Full Federal Court proceeded to conclude, which also will be evident from the passages of its judgment quoted earlier:

The applicant's claim was to an accounting for a capital profit or gain made by Mr Murdoch and to an entitlement to a constructive trust over the assets of the trust estate, and she was paid the Lump Sum in satisfaction of those claims.²⁸

As to how the Full Federal Court reached that conclusion with regard to the terms of the settlement deed, and particularly with regard to the claims enumerated as (a) to (d) in clause 2.1 of the settlement deed (quoted earlier), cannot be discerned from its judgment, which is a fatal deficiency. What, in that respect, the Full Federal Court did say (as quoted earlier) was the following, which, though, does not explain how it reached that conclusion:

In his second opinion, Mr Heydon QC thought the principle recognized in *Phipps v Boardman* was arguably applicable to the circumstances of Mr Murdoch's dealings with the trust estate. Mr Murdoch clearly stood in a fiduciary relationship to the applicant. If the applicant could prove the matters recited in paras (i), (ii) and (iii) of Recital J of the Settlement

²⁶ *Murdoch* [2007] AATA 1791, para 25.

²⁷ *Murdoch* [2008] FCAFC 86, para 27.

²⁸ Above n 27, para 27.

Deed, a *Phipps v Boardman* claim for an accounting would be made out.

²⁹
...

That passage can be given effect to only in the context of clause 2.1 (c) of the settlement deed, a clause to which recital J (iii) of that deed relates. The essence of that clause 2.1 (c) is that, as one beneficiary of a trust, Mr Rupert Murdoch owed a fiduciary duty to the taxpayer, who was another beneficiary of the same trust, and that there had been a breach of that duty. That duty, of course, is owed to the taxpayer in her capacity as a beneficiary of that trust, a status which is necessarily determined according to the terms of that trust. In accordance with those terms, the taxpayer was a life tenant of the trust with an entitlement to only distributions from that trust of its income (not capital).

The breach of that duty by Mr Rupert Murdoch, it follows, was a breach whose consequence was that the taxpayer was denied the receipt of distributions of income to which she was otherwise entitled from that trust (as she had no entitlement to anything else, including capital, from that trust). Any compensation that she receives (in a lump sum or otherwise) for that breach must, accordingly, in her hands, necessarily bear the character of income.

Here that entitlement to compensation, in the circumstances, may well be measured as what amount of capital profit Mr Rupert Murdoch, in his capacity as the sole remainderman of that trust, may be entitled to, by way of a capital distribution from that trust to him. That distribution, if indeed made by that trust to Mr Rupert Murdoch, will, in his hands, be a capital (not income) receipt. This, however, has no bearing in determining the proper character, in the taxpayer's hands, of the compensation which the taxpayer received, pursuant to that entitlement, for a breach of a duty owed to the taxpayer in terms of that trust.

In summary, therefore, the Full Federal Court erred as it misapprehended what was, in fact, merely the method of measurement of the compensation received by the taxpayer to be determinative of the character of that compensation in the hands of the taxpayer. What was truly determinative of that character was, as noted earlier, the substance of the release granted by the taxpayer. That release, in terms of clause 2.1 (c) of the settlement deed, is that of a claim of the taxpayer in her capacity as a life tenant of that trust with an entitlement to only distributions of income (not capital) made by that trust.

VI CRITICAL ASPECTS OF THE AAT'S ANALYSIS NOT ADDRESSED IN THE FULL FEDERAL COURT'S DECISION

As noted earlier, the AAT, in addressing the question of what was the substance of the release granted by the taxpayer, did so with proper regard to the exact terms of the settlement deed, something which the Full Federal Court did not. The AAT also, relative to the Full Federal Court, more extensively, and more critically, evaluated the advice contained in the first opinion and the second opinion (provided by Mr Heydon QC), as canvassed below. The AAT did so despite its concession thus as to that advice of Mr Heydon:

It is not readily apparent why the barrister's opinion is pertinent to the resolution of the issues before me. However, there was no objection to the tendering of the two opinions and the parties made reference to them.

²⁹ Above n 27, para 24.

Nevertheless, it is for me to determine whether the lump sum paid under the deed was received as capital or income. The opinions do provide some evidence of the circumstances surrounding the execution of the deed. However, they cannot assist in construing the deed in the absence of supporting evidence and submissions.³⁰

That concession of the AAT is entirely correct. The AAT observed:

The passages in the Queen Counsel's first opinion suggest that any remedy for breach of trust flowing from improper exercise of the power of investment would reflect lost income. In that I think he was right.³¹

The passages of the first opinion that the AAT refers to in that observation must be the following paragraphs (of the first opinion), which were quoted earlier:

Whether the various trustees are liable for breach of trust to Dame Elisabeth Murdoch is thus a difficult question. If they were, the quantum of compensation for that breach may be hard to calculate but in principle it would be the difference what the income of the assets could have been had they been invested in a mix of blue chip shares and other authorized investments producing a reasonable income, and what Dame Elisabeth actually received.³²

Alternatively, on the reasoning in paragraph 254 [of Scott on Trusts (4th edition)], a court might hold that there was a constructive trust which could be vindicated by a sale of the property subject to the constructive trust (or, on the earlier analysis, subject to the charge): the proceeds of the sale could then be applied partly to compensate the tenant for life for past losses and thereafter reinvested on more appropriate securities.³³

The first of those two paragraphs describes the compensation the taxpayer is entitled to as the quantum of the income that she ought to have received from the trusts by way of distributions to her, but which she did not receive. The second of those two paragraphs describes the compensation the taxpayer is entitled to as recompense for "past losses". Both of those descriptions are consistent with the conclusion the AAT reached "that any remedy for breach of trust flowing from improper exercise of the power of investment would reflect lost income".

Last, the AAT offered a most tenable analysis of why *Phipps v Boardman* does not apply in *Murdoch*, an analysis which the Full Federal Court did not attempt to refute, which it must have, as it overturned the decision of the AAT in *Murdoch*. This analysis of the AAT was described by it in the following terms:

It is, accordingly, easy to posit a case in which a person acquires shares which are impressed with a charge or constructive trust because of the person's fiduciary relationship. But that is a very long way from the present matter. The conduct prescribed in *Boardman* and similar cases is the taking of an asset by a fiduciary which is in reality a trust asset. What is said here is that the trust funds should have been invested in different assets. The remedy in a *Boardman* case is imposing a charge or constructive trust upon assets of the fiduciary in favour of the trust. Here, the remedy was the imposition of a charge or constructive trust on the trust assets in favour of a beneficiary. In *Boardman* no question of the

³⁰ *Murdoch* [2007] AATA 1791, para 17.

³¹ Above n 30, para 35.

³² Above n 30, para 14.

³³ Above n 30, para 14.

entitlement of the beneficiary to the benefit of a charge or constructive trust arose. The ‘beneficiary’ of the charge or trust was the original trust and not a beneficiary; certainly not a beneficiary with only a life interest in income. The statement that *Boardman* leads to a charge or trust over assets needs to be seen in this context. Obviously, that will be the case when an asset held by a fiduciary belongs to a trust. The fiduciary will be a bare trustee for the trust. The trust imposed will be a separate trust arising by operation of law and will not be some manifestation of the existing trust. When the assets subject to that separate trust are transferred to the original trust, they will become part of the original trust’s assets, subject to that trust’s terms.

It follows that *Boardman* does not assist the taxpayer. First, the conduct giving rise to the charge or trust is quite different. Secondly, no question of a charge or trust directly in favour of a beneficiary [sic: the word ‘beneficiary’ should perhaps have been ‘trust’] arises.

As will be evident from the passages of the Full Federal Court’s judgment quoted earlier, reliance on *Phipps v Boardman* was absolutely crucial to the holding the Full Federal Court reached in its decision. That being so, it is pivotal that the Full Federal Court refuted the analysis of the AAT as to why *Phipps v Boardman* does not apply in *Murdoch*, as described by the AAT in the passages quoted just above. The Full Federal Court, in its judgment, did not refute so, which is a fatal deficiency.

VII CAN THE FULL FEDERAL COURT’S DECISION BE JUSTIFIED BY AN ANALYSIS NOT ARTICULATED IN ITS JUDGMENT?

One may argue that the Full Federal Court’s decision can be justified by an analysis not articulated in its judgment. One could conceive two such possible analyses, the first of which is as follows.

The lump sum which the trusts paid the taxpayer was equal to the proceeds realized from by the trusts from the happening of CGT event A1 (that is, the disposal of a CGT asset) or CGT event C2 (that is, the redemption or cancellation of an intangible CGT asset) to assets acquired by the trusts before 20 September 1985. Any capital gain made by the trusts from those CGT events, accordingly, is ignored for purposes of income tax. Any distribution of those capital gains by the trusts to the taxpayer in the income year in which those CGT events happened (as the taxpayer is presently entitled in that income year to those capital gains) is also, accordingly, ignored for purposes of income tax in the hands of the taxpayer.

In the author’s view, this analysis is not tenable in the context of the case since in terms of the trusts all that the taxpayer was entitled to from the trusts was income (and not capital). Therefore, the trusts could never have distributed to the taxpayer any capital gains, as, by their very nature, capital gains (though they may be assessable income) can never be income. This conclusion is consistent with the position that, in *Murdoch*, at the Full Federal Court, it was not contended by the Commissioner or the taxpayer that the lump sum received by the taxpayer from the trusts was a distribution by the trusts to the taxpayer of “net income” (which includes capital gains not ignored for purposes of income tax) of the trusts.

The second of those two analyses is as follows. The lump sum received by the taxpayer was not, in fact, received from the trusts but, rather, from the

remainderman. That is, the trusts made capital gains which are ignored for purposes of income tax from the happening of CGT event A1 (that is, the disposal of a CGT asset) or CGT event C2 (that is, the redemption or cancellation of an intangible CGT asset) to assets acquired by the trusts before 20 September 1985. The trusts then distributed to the remainderman those capital gains, which retained their character, in the hands of the remainderman, as capital gains which are ignored for purposes of income tax. The remainderman thereafter used those capital gains to pay to the taxpayer the lump sum in question.

This analysis, of course, is premised on the terms of the trusts permitting a distribution (albeit a distribution of capital, not income) by the trusts to the remainderman during the lifetime of the life tenant (that is, the taxpayer). One has to assume that the terms of the trusts so permitted, since there is no reliable basis to discern the relevant terms of the trusts.

This too, is an analysis which is not tenable in the context, for the following reasons (which have been explained earlier). The remainderman (Mr Rupert Murdoch) can become obligated to make the payment of the lump sum to the taxpayer only in the context of clause 2.1 (c) of the settlement deed, a clause to which recital J (iii) of that deed relates. The essence of that clause 2.1 (c) is that, as one beneficiary of a trust, Mr Rupert Murdoch owed a fiduciary duty to the taxpayer, who was another beneficiary of the same trust, and that there had been a breach of that duty. That duty, of course, is owed to the taxpayer in her capacity as a beneficiary of that trust, a status which is necessarily determined according to the terms of that trust. In accordance with those terms, the taxpayer was a life tenant of the trust with an entitlement to only distributions from that trust of its income (not capital).

The breach of that duty by Mr Rupert Murdoch, therefore, it follows was a breach whose consequence was that the taxpayer was denied the receipt of distributions of income to which she was otherwise entitled from that trust (as she had no entitlement to anything else, including capital, from that trust). Any compensation that the taxpayer receives (in a lump sum or otherwise) for that breach must, accordingly, in her hands, necessarily bear the character of income.

The taxpayer's entitlement to compensation, in the circumstances, may well be measured as what amount of capital profit Mr Rupert Murdoch, in his capacity as the sole remainderman of that trust, may be entitled to by way of a capital distribution from that trust to him. This has no bearing in determining the proper character, in the taxpayer's hands, of the compensation which the taxpayer received, pursuant to that entitlement, for a breach of a duty owed to her in terms of that trust.

VIII POLICY IMPLICATIONS OF *MURDOCH*

Since 1976, the High Court will hear an appeal only after it has granted special leave to hear that appeal. It has been reported that the High Court only grants special leave to hear an appeal against a decision of the Full Federal Court with respect to questions of federal tax law in 'exceptional cases'.³⁴ Nevertheless,

³⁴ *Commissioner of Taxation v Westfield* (1991) 22 ATR 400 at 402 (Mason CJ).

in reality the High Court frequently grants special leave to hear appeals against decisions of the Full Federal Court on questions of income tax.³⁵

There is no basis to reliably discern why the Commissioner decided not to seek special leave of the High Court to appeal against the Full Federal Court's decision in *Murdoch*. The only authoritative pronouncement in that respect which one can have reference to is the *Decision Impact Statement on Murdoch* issued by the Australian Taxation Office, which is referred to in footnote 2. That *Decision Impact Statement*, however, sheds no light on why the Commissioner decided not to seek such special leave of the High Court.

Murdoch turned on whether a lump sum of as much as \$85,087,176 was income (or capital) of an individual (not a large corporate entity). The income tax at stake, therefore, was, by no means, insignificant. The Commissioner rightly decided that the taxpayer's contention that lump sum was capital was one which should be adjudicated. Furthermore, the AAT, in a decision reasoned with considerable discipline, held for the Commissioner. The fact that the decision of the Full Federal Court, unanimous though it was, overturned the decision of the AAT cannot, in the circumstances, support a conclusion that the Commissioner could, therefore, have resigned to the position that there was no merit in contesting the Full Federal Court's decision. That is especially so as the Full Federal Court's decision, as argued in this article, is not supported by an analysis that comprehensively refutes the analysis that underpinned the decision of the AAT.

Murdoch evinces a need to strengthen the controls applicable to the conduct of the Commissioner. It is submitted that legislative or administrative controls must be instituted which require the Commissioner to explain, through public pronouncement, his reasons for not seeking special leave of the High Court to appeal a decision of the Full Federal Court (such as in *Murdoch*). Such controls will enhance the proper discharging of accountability by the Commissioner, in his capacity as the holder of a very significant public office.

IX CONCLUSION

So far as can be discerned from the decision of the Full Federal Court, the Commissioner's submissions to it seemingly did include exactly the analysis articulated in this article. That analysis is, as noted earlier, not dissimilar to the analysis upon which the AAT reached its decision that the lump sum settlement received by the taxpayer rightly was her income.

For the reasons canvassed in this article, the Full Federal Court erred in *Murdoch* in deciding that the lump sum settlement received by the taxpayer was not her income. It erred so as it failed to draw the proper conclusion upon applying the relevant law to the facts. That failure is manifested in two fatal deficiencies in the Full Federal Court's decision:

- First, it cannot be discerned from the Full Federal Court's judgment as to how it reached, with regard to the terms of the settlement deed, and particularly with regard to the claims enumerated as (a) to (d) in clause 2.1 of the settlement deed, the conclusion that the taxpayer's 'claim was to an

³⁵ The Hon Justice Michael Kirby, 'Hubris contained: why a separate Australian Tax Court should be rejected' (2007) 42(3) *Taxation in Australia* 161.

accounting for a capital profit or gain made by Mr Murdoch and to an entitlement to a constructive trust over the assets of the trust estate, and she was paid the Lump Sum in satisfaction of those claims’.

- Second, the Full Federal Court, in its judgment, failed to refute the analysis of the AAT as to why *Phipps v Boardman* does not apply in *Murdoch*.

The Commissioner, accordingly, should have sought special leave of the High Court to appeal against the Full Federal Court’s decision in *Murdoch*. The Commissioner has erred in not seeking such special leave.

In the author’s view, legislative or administrative controls must be instituted which require the Commissioner to explain, through public pronouncement, his reasons for not seeking special leave of the High Court to appeal a decision of the Full Federal Court (such as in *Murdoch*). Compliance with such controls will enhance the proper discharging of accountability by the Commissioner, in his capacity as the holder of a very significant public office.