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## FOREWORD

The papers included in this edition of the Journal of the Australasian Tax Teachers Association (JATTA) are derived principally from papers presented at the 23rd Annual Conference of the Australasian Tax Teachers Association (ATTA) held over Wednesday 19 January to Friday 21 January 2011 at the University of Melbourne, Melbourne, Australia.

The theme of the conference was “Tax – it’s more than numbers”. The range of papers presented at the conference demonstrated the truth of the proposition that tax is both about the quantification of each person’s contribution to the public fund and also about the policy choices inherent in framing and applying those rules. The papers presented in this volume reflect the breadth of Australasian research with respect to taxation.

The production of this volume would not eventuate without the efforts of many who give so willingly of their time. The peer reviewers who each anonymously provide exemplary guidance to authors in assisting authors to strengthen their respective papers deserve special mention – this is an onerous task which is of immense benefit to the authors specifically and to the scholarly community in which the Australasian Tax Teachers Association is a vibrant hub. Ms Kerry Brewster painstakingly proofread the papers and Ms Tessa Dermody oversaw the production of this volume – a special vote of thanks to both of you. Finally, we owe thanks to the authors who share their knowledge in contributing to deliberation upon how a community might understand and/or improve its taxation system.

Mark Burton  
Law School, University of Melbourne  
20 December 2011

**THE IMPACT OF OECD MEMBERSHIP UPON NEW ZEALAND'S INTERNATIONAL TAX POLICY AND  
DTA NEGOTIATIONS –A COMPARATIVE TEXT ANALYSIS**

ANDREW M C SMITH AND ADRIAN J SAWYER\*

**ABSTRACT**

The Organisation for Economic Cooperation and Development (OECD) has played a significant role in the area of taxation since its inception in 1961. Among its contributions to international tax coordination was the release of a draft model tax convention, revised many times subsequently, which has been adopted by many countries as a template for them to negotiate their double tax agreements (DTAs) from.

New Zealand was not one of the founding members of the OECD. New Zealand joined the OECD in 1973, following Australia in 1971 and Japan in 1964. New Zealand's later entry into the OECD after the Draft Model Convention first appeared in 1963 provides an interesting opportunity to examine the extent that OECD membership has influenced New Zealand's DTA negotiations and international tax policy, using as a primary analysis tool a computer based text comparison programme.

The results obtained show that prior to joining the OECD none of New Zealand's DTAs were based on the OECD Model. Only after it joined the OECD and entered its reservations to the 1977 version of the OECD Model did that Model have any influence upon New Zealand's DTA negotiations. Now nearly forty years on since joining, New Zealand has a network of 37 DTAs, most of which are based upon the OECD Model. Despite this, all of these DTAs depart in some areas from the OECD Model, the reasons for which are analysed further in this article.

Overall it appears the OECD Model has assisted New Zealand's DTA negotiations enabling it also to enjoy the benefits flowing from the international acceptance of the Commentaries as a tool for interpretation. The OECD Model may have also made it harder for New Zealand to negotiate DTAs with articles that differ substantially from international tax norms and has probably been a factor behind some of the latest changes to New Zealand's international tax rules.

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## I INTRODUCTION

The Organisation for Economic Cooperation and Development (OECD) has played a significant role in international tax matters since its inception in 1961. Building on work done by the League of Nations in the 1920s and later the OECD's predecessor organisation, the Organisation for European Economic Co-operation (OEEC), the OECD released a draft model tax convention in 1963. This model convention has subsequently become adopted by many countries as a template for them to negotiate their double tax agreements (DTAs) from. In parallel with the emergence of the OECD Model Agreement as the basis for DTA negotiations, the OECD itself has become the preeminent international forum for the examination and discussion of tax and public finance issues.

New Zealand was not one of the founding members of the OECD. The OECD's origins were from a pan American-European organisation, the OEEC, which was established in 1948 as part of the Marshall Plan for United States (US) economic assistance for the reconstruction of Europe after World War II, which obviously did not concern New Zealand. New Zealand's accession to the OECD did not occur until 1973, following Australia in 1971 and the first non-European/American member, Japan, in 1964.

New Zealand's entry into the OECD after the OECD Draft Model Convention appeared in 1963 provides an interesting opportunity to examine the extent that OECD membership has influenced New Zealand's DTA negotiations and international tax policy, using as a primary analysis tool a computer based text comparison programme. The results obtained show that OECD membership has had a pronounced effect upon New Zealand's DTA negotiations, leading to a network of 37 DTAs today, most of which are based upon various versions of the OECD Model Convention. Despite this influence of the OECD Model, New Zealand's DTAs do not consistently adhere to the OECD Model in every respect and in a number of areas feature significant departures from it which are categorised and analysed in this article.

The remainder of this article is organised as follows. In the next section a brief statement of the research method employed in this study is laid out, which is followed in section 3 with a review of the role of the OECD in international tax matters. Section 4 then discusses New Zealand's early DTAs prior to it joining the OECD, which is followed in section 5 by the developments after its accession to the OECD. Section 6 briefly considers the effect that the OECD Model has had on New Zealand's international tax policy. Finally section 7 sets out our conclusions.

## II RESEARCH METHOD

In this article we utilise a text comparison function imbedded in a well-known and widely used word processing programme (Microsoft Word 2007) to analyse and review New Zealand's DTAs from the first one negotiated in 1947 with the UK to the latest one (at the time of writing in mid 2011) negotiated with Hong Kong. The analysis in this article focuses on two periods in which DTAs were negotiated by New Zealand, namely before and after New Zealand's accession to OECD membership.

The text comparison function contained in MS Word 2007 produces a single comparison report specifying the additions, deletions and common text between two different text

documents. Using this text comparison function, a comparison report was produced for each of New Zealand's DTAs showing the results of a comparison between it and the corresponding version of the OECD Model when it was negotiated. These reports were used to analyse the content of New Zealand's DTAs to identify trends, similarities and themes in their drafting, as well as areas of departure from the OECD Model with a high level of detail. The text comparison function enables subtle wording differences to be identified and highlighted, making what would otherwise be a substantial and resource intensive exercise possible. This computer-based text comparison also enables patterns in departures from the OECD Model to be identified which are useful in identifying policy points in New Zealand's DTA negotiations which have not usually been publicly discussed or canvassed in policy documents. This is particularly so where paragraphs in OECD Model articles have been supplemented by additional paragraphs inserted at the request of New Zealand or one of the other treaty partners being a common point of departure in many of New Zealand's DTAs from the OECD Model. The use of computer-based text analysis is less useful at determining whether two articles prescribe much the same treatment but using different words. This, however, is less of an issue in this article as this only arises with DTAs New Zealand has negotiated prior to it adopting the OECD Model for its DTA negotiations.

### **III ROLE OF THE OECD IN INTERNATIONAL TAX MATTERS**

Since its inception in 1961 the OECD has played a preeminent role in international tax matters. Not long after its establishment in 1961, it released a draft model tax convention in 1963, followed by a revised version in 1977 which has been regularly revised at more frequent intervals up to the present day. The OECD Model, as it has come to be known, has become the template for DTA negotiations between member states and also with many non-member states.

The OECD has no powers of compulsion in international tax matters. It is a forum of sovereign states represented by their governmental officials. The OECD recommends that member states negotiate DTAs between each other which is a recommendation widely followed by OECD members.

The Council of the OECD also recommends that when members are negotiating DTAs, the agreements should conform to the OECD Model as interpreted by the Commentaries, having regard to any reservations noted.<sup>1</sup> As a result of this recommendation, the DTAs negotiated by member states tend to have a high degree of uniformity between them which is intended by the OECD as being the most appropriate way to address international tax issues:

It has long been recognized among the Member countries of the OECD that it is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other

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<sup>1</sup> The intended role of the Commentaries to the OECD Model Tax Convention in the interpretation of DTAs based on the OECD Model has been expressly recognised by the New Zealand Court of Appeal in *CIR v JFP Energy Inc* (1990) 12 NZTC 7,176. New Zealand is also a signatory to the Vienna Convention on the Law of Treaties negotiated in 1969.

countries through the application by all of common solutions to identical cases of double taxation.<sup>2</sup>

The appearance of the words “standardize” and “common solutions” emphasises that the OECD wishes member states to enter into arrangements that are broadly comparable, which is consistent with the highly degree of uniformity seen between most of the DTAs negotiated by members, whether with other members or non-member states.

This influence of the OECD Model, and the emphasis in the accompanying Commentaries for standardised and common solutions to resolve problems of double taxation, provides an interesting platform for addressing the issues that are the focus of this article due to the adoption of text comparison as the research method.

#### **IV NEW ZEALAND’S EARLY DTAs PRIOR TO OECD MEMBERSHIP**

##### ***A Background***

Despite legislating for the taxation of its residents’ worldwide incomes in 1916, New Zealand was slow to enter into bilateral treaties to address the problems of international double taxation. When residence based taxation was introduced in 1916, the resulting problem of international taxation was addressed by exempting from New Zealand tax any income which had been derived in and had borne tax in other jurisdictions of the British Empire. This exemption was not made pursuant to any bilateral or multilateral treaties but based on a mutual understanding between the British dominions and the United Kingdom (UK).<sup>3</sup> No relief of any kind was provided against double taxation on income derived from non-British sources including any deduction for foreign taxes against New Zealand assessable income which often lead to harsh outcomes as was noted by the Gibbs Committee in 1951.<sup>4</sup> This situation also reflects New Zealand’s focus and high degree of reliance on the UK and the British Empire generally, along with the limited ability for New Zealand residents to access and utilise funds internationally.

Reflecting New Zealand’s status as a capital importing country, from when income tax was imposed in New Zealand it sought to protect and (to some degree) extend its source taxing rights. Unsurprisingly, this assertion of source taxing rights brought it into conflict with other states. Until the early 1960s, any business obtained by a non-resident trader from New Zealand through an independent agent on their behalf was deemed to be sourced in New Zealand. This lead to threats of retaliation against New Zealand traders in the 1930s which resulted in New Zealand granting exemptions for non-resident traders on a reciprocal basis if New Zealand traders would be similarly exempt. This matter also led New Zealand to enter into its first bilateral treaties concerning income tax with the UK and Canada addressing the taxation of non-resident traders. Another example of New Zealand’s assertion of source taxing rights was to

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<sup>2</sup> *OECD Model Tax Convention on Income and on Capital*, 2008, OECD Paris, Introduction, [2].

<sup>3</sup> For a history of Dominion tax relief in the UK see P Harris, ‘An Historic View of Principle and Options for Double Tax Relief’ (1999) 6 *British Tax Review*, 469, 473-476.

<sup>4</sup> See Taxation Committee (T N Gibbs Chairman, R E Owen), *Report of the Taxation Committee*, (1951), 98-99, [415].



deem the income of non-resident shipping companies derived from the carriage of goods from New Zealand to be New Zealand sourced. This too brought New Zealand into conflict with other countries that followed the emerging standard that international transport enterprises would only be taxed in the jurisdiction where they were headquartered.

By today's standards these issues may appear trivial. They are important, however, in the context of the analysis contained in this article as illustrations of how New Zealand in earlier times had attempted to maintain international tax policies which were at variance with international norms, even those existing in the 1930s.

New Zealand's first comprehensive DTA was not entered into until 1947 when it negotiated a DTA with the UK. This DTA was concluded as a result of an offer by the UK Government to negotiate DTAs with its dominions after it had negotiated its first comprehensive DTA in 1945 with the US.

After the negotiation of the UK DTA in 1947, New Zealand slowly extended its DTA network. It negotiated DTAs with Canada and the US shortly after the UK one in 1947, but only two further agreements were negotiated in the next decade - one with Sweden in 1956 and another with Australia in 1960. The 1960s saw New Zealand's DTA network extend by one to include Japan in 1963 although the 1947 UK DTA was renegotiated and updated in 1966. New Zealand's DTA negotiations were similarly limited in the early-to-mid 1970s with only three new DTAs signed in this period (being with Singapore 1973, and Malaysia and Fiji in 1976) while the earlier DTA with Australia was renegotiated and updated in 1972. Not until it entered its reservations and observations to the 1977 OECD Model Convention did New Zealand start to extend its DTA network to one commensurately broad for an OECD member state.

### ***B Analysis of New Zealand's DTAs Negotiated Prior to the 1963 OECD Draft Model***

In the period from when New Zealand entered its first comprehensive DTA in 1947 until when it entered its reservations and observations to the OECD Model in 1977, it concluded only eleven DTAs with nine countries. It has not been officially disclosed whether a model convention or template was used in these early DTA negotiations, nor whether ones negotiated in the latter part of that period up to 1977 were based on the OECD Draft Model released in 1963. One way these questions can be answered is through the use of a text comparison analysis as adopted in this article.

New Zealand's first DTAs (being those with the UK and Canada in 1947 and 1948, respectively) followed a similar pattern. The number of articles in these DTAs was approximately half those found in a modern agreement based upon the OECD Model Tax Convention. Articles covering business profits, associated enterprises, shipping and air transport, royalties, government service, pensions, professors, students, along with an article to relieve double taxation by requiring foreign tax credits to be granted on a reciprocal basis, were included as well as ones dealing with administrative matters such as information exchange, entry into effect and termination. Also of note in respect of these two DTAs:

- The royalty article in the Canadian DTA applied only to copyright royalties, while the UK DTA contained a more expansive definition which also included industrial royalties

except those relating to mining and natural resource exploitation. The leasing of scientific and industrial equipment was not brought within the scope of the royalty article in either treaty.

- Royalties were exempt from tax in the source state in both DTAs.
- Any business of insurance carried on in New Zealand by a resident of the other contracting state was not covered by the business profits article; however, the converse did not apply. These provisions reflected New Zealand's longstanding policy of reserving the right to tax non-resident insurers under its domestic rules.
- The personal services articles were not clear whether they applied to independent personal services (that is, independent contractors) or employees or both. The respective articles contained wording, parts of which are found in both the independent and dependent personal services articles of more modern DTAs.
- The definitions of "permanent establishment" (PE) were considerably briefer than what is found in modern DTAs today.
- The dividend article in the UK treaty provided for an exemption in the residence state, although dividends paid by New Zealand to UK residents could be taken into account for tax rate scale purposes. Dividends were not covered at all in the Canadian DTA.
- Interest was not covered in either DTA.
- Neither the UK nor Canadian DTAs contained a residence "tie-breaker" clause.

Many matters covered in modern DTAs were not addressed at all. There were no articles dealing with alienation of property, artistes and sportsmen, diplomats or other income. More importantly, there were no articles covering a mutual agreement procedure. On the other hand, there was an article dealing with visiting professors, which is not found in modern DTAs, or in any version of the OECD Model. This may in part be attributed to the typical situation that a university professor would take a year's sabbatical leave and spend this time in another country, usually with another member of the British Commonwealth or in North America.

A text comparison analysis shows some degree of commonality between these two DTAs. This suggests that there was a draft convention of British origins used as a basis for negotiations, possibly one from the UK given that the UK had offered to negotiate DTAs with its dominions (New Zealand, Australia, Canada and South Africa), after concluding its first comprehensive DTA with the US in 1945.

Interestingly, a comparison of this 1945 UK-USA DTA with the DTAs New Zealand negotiated with the UK and Canada shortly after, shows they had little in common, reinforcing the view that a British drafted model (or template) came into existence after the 1945 DTA with the US was negotiated.

The DTA New Zealand concluded with the US in 1948 contained a similar number of articles as the UK and Canadian ones; however, some matters were dealt with in a different manner. The dividend article permitted source taxation of 15 percent on dividends with a reduced rate of 5 percent applying to dividends if the payee was 95 percent or more owned by the recipient of the dividend. Special provision was made for the New Zealand film hire tax imposed on non-resident film renters.

A text comparison analysis confirms that this treaty had very little in common with the UK and Canadian treaties negotiated around the same time. It seems probable that this DTA New Zealand negotiated with the US was based upon a draft supplied by the US given the absence of any commonality with the UK and Canadian DTAs.

New Zealand negotiated three more DTAs before the release of the OECD Draft Model in 1963. These DTAs were with Sweden in 1956, Australia in 1960 and Japan in 1963. The Swedish DTA was New Zealand's first to include an interest article. Interest and royalties were to be taxed on a split basis 60/40 in favour of the source state allowing the source state to maintain their domestic law treatment on the 60 percent allocated to them. This arrangement was not followed in any subsequent New Zealand DTA and therefore is unique. A text comparison analysis shows there was some carryover of articles from the 1947 UK DTA to this agreement suggesting that New Zealand's first DTA had been influential to some extent in subsequent negotiations. This may have been due to language considerations or that New Zealand's negotiators prevailed in some areas for wording from the earlier UK DTA to be adopted.

Surprisingly, there was less carryover from the 1947 UK DTA to New Zealand's first DTA with Australia signed in 1960. The origins of this treaty are unknown but appear not to be closely linked to the UK DTA.

New Zealand signed a DTA with Japan in 1963 which was the result of a number of meetings with Japanese negotiators going back to the late 1950s. Although it was signed in the same year as the OECD Draft Model Convention was released, it has nothing at all in common with the 1963 OECD Draft Model. A text comparison analysis also shows that this DTA had little in common with any of New Zealand's earlier DTAs although some paragraphs are the same as those appearing in the UK 1947 DTA. Again this supports a conclusion that these may be areas where New Zealand negotiators prevailed, possibly reflecting their comfort and familiarity with existing provisions from New Zealand's first DTA signed with the UK in 1947.

### ***C New Zealand's DTAs negotiated after the 1963 OECD Draft Model but before New Zealand's OECD Accession***

After the release of the OECD Draft Model in 1963, New Zealand negotiated one more DTA in the 1960s. This was a new DTA with the UK to replace the earlier 1947 agreement. This agreement is New Zealand's first where the newly released OECD Draft Model Convention could potentially have had some influence, especially since the UK was a founding member of the OECD.

This DTA is notable for the comprehensive range of articles it included compared to a much smaller number in the 1947 DTA. However, apart from that aspect, a text comparison analysis shows it has little in common with the 1963 OECD Draft Model. This agreement is significantly different to the earlier one it replaced, and with the UK's membership of the OECD there must have been some chance the OECD Model (to which they would have been presumably a party to its drafting), would have influenced the negotiations. This appears not to have been the case, possibly indicating that the OECD Model had not met with wide acceptance in the mid-1960s as it would achieve in later decades or that the UK was happier to continue with DTA negotiations based upon their models which were in existence prior to the release of the 1963 Draft Model.

In the 1970s, up to when New Zealand first entered its reservations and observations to the 1977 OECD Model, it negotiated four DTAs. The first was one with Australia in 1972

to replace the earlier one negotiated in 1960. As Australia only joined the OECD in 1971, negotiations for this new DTA would have started prior to Australia's accession to the OECD. Unsurprisingly, a text comparison analysis shows that this new DTA with Australia had little in common with the 1963 OECD Model.

New Zealand negotiated three new DTAs with Singapore, Malaysia and Fiji between 1973 and 1976. Two of these (Malaysia and Fiji) were concluded after New Zealand's accession to the OECD, while the Singaporean one was signed the same year as New Zealand's accession. Negotiations for the Singaporean DTA go back to 1968 while the other two commenced around 1970. Interestingly all three DTAs have a high degree of commonality and appear to have been negotiated from the same model or draft agreement; however, a text comparison analysis shows that they are not based on the 1963 OECD Model. The high degree of commonality between the Malaysian and Singaporean DTAs is not surprising as New Zealand had close relations with both Singapore and Malaysia and did not want to be seen to favour one over the other.

In conclusion it can be seen that New Zealand's DTA negotiations prior to its accession to the OECD appear not to be influenced by any underlying model to any great extent. Given that New Zealand had taken the stance that it would not initiate DTA negotiations, but only enter into them in response to a request from another country, it may have resulted in negotiations starting from models or drafts supplied by the other state. In the early stages there were significant differences between each DTA, suggesting that devising standardised solutions to international tax problems was not seen as important, or possibly the differences may have been the result of not basing negotiations upon an internationally accepted model, as the OECD Model has come to be.

## **V ACCESSION TO OECD – DTAs FROM 1978 ONWARDS**

### ***A Introduction***

New Zealand joined the OECD in 1973. One requirement of membership was for New Zealand to state its position on the OECD Model by entering any reservations and observations it had to it. New Zealand initially managed to delay this process by determining its reservations and observations with respect to the 1977 version of the OECD Model and not the 1963 Draft Model. It deferred starting any DTA negotiations with other OECD members until the 1977 Model Agreement had been released even though it concluded three more DTAs in the period 1973 to 1976 as explained in the previous section. None of these DTAs were with OECD members and they were all the result of negotiations which had commenced prior to 1973.

After New Zealand had entered its reservations and observations to the 1977 OECD Model Agreement, it commenced negotiations with a number of OECD members and in a relatively short period of time DTAs were concluded with Germany (1978), France (1979), Italy (1979), Netherlands (1980), Switzerland (1980), Denmark (1980), Belgium (1981), Finland (1982), and Norway (1982). In addition four existing DTAs were renegotiated in the same period - Sweden (1979), Canada (1981), US (1982) and the UK (1983) - in each case the earlier DTA was replaced with one based upon the

1977 OECD Model.<sup>5</sup> Also in the same period New Zealand negotiated DTAs with a number of non-OECD states mainly in the Asia region. Starting with the Philippines in 1980, DTAs were concluded with South Korea in 1981, and China, India and Indonesia all in 1986.

A text comparison analysis shows that all of New Zealand's DTAs negotiated after its input to the 1977 OECD Model have been based upon the OECD Model including those negotiated with non-OECD states. While the fact that the DTAs concluded with other member states follow the OECD Model reflects New Zealand's adherence to OECD recommendations (and the obligations of membership), the fact that all the DTAs negotiated by New Zealand with non-member states since its accession to the OECD also follow the OECD Model suggests something more. It appears that New Zealand saw advantages from negotiating DTAs based on the OECD Model, especially the benefits of the Commentaries in interpreting and applying DTAs based on the OECD Model. It may also have been indicative of a similar acceptance by non-members of the OECD Model, especially since the Commentaries also incorporate input from non-member states, including a number from Asia, in recent times. Another advantage following from the OECD Model for both New Zealand and non-member states would be the efficiencies the OECD Model would have provided for DTA negotiations.

While New Zealand has adopted the OECD Model in all of its DTA negotiations starting with the 1978 German DTA, none of them follow the OECD Model in its entirety. There is a pattern in all of New Zealand's DTAs of departures from the text of the OECD Model, usually in similar ways. These departures are not unique to New Zealand DTAs; all member states depart from some parts of the OECD Model when negotiating DTAs to a lesser or greater extent.

A text comparison analysis enables these departures from and differences to the OECD Model in New Zealand's DTAs to be identified and analysed. They can be categorised as follows:

- Matters where Reservations/Observations have been entered to the OECD Model.
- Changes to terminology and phrasing resulting in differences of minor nature.
- Adoption of alternative text from the Commentaries to the OECD Model.
- Revised wording to address deficiencies in the drafting of some articles from the OECD Model highlighted by court decisions.
- Retention of provisions from earlier versions of the OECD Model.
- Clarification and enhancement of articles from the OECD Model.
- Articles concerning taxes which the OECD Model does not cover.

### ***B Matters Where Reservations/Observations Entered to the OECD Model***

An obvious reason for departure from the OECD Model is in respect of articles to which either New Zealand and/or the other contracting state have entered reservations or

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<sup>5</sup> Interestingly, it was not until 1995 that New Zealand revised its DTA with Australia to one based upon the OECD Model and in 2009 the Singapore DTA was updated to one based on the OECD Model. As at time of writing only three of New Zealand's DTAs, which are currently in force, are not based upon the OECD Model, namely the agreements with Japan (1963), Malaysia (1976) and Fiji (1976).



observations. The number of reservations entered by New Zealand appears average by OECD standards, and all member states have entered reservations or observations to the OECD Model to some extent.

In respect of Article 5, New Zealand wishes to retain the right to deem construction and assembly projects a PE if they exist for longer than 6 months, not 12 months as found in the OECD Model. In about half of New Zealand's DTAs, construction projects become a PE after 6 months, while in the remainder the 12 month rule prevails.

In respect of Article 7, New Zealand has entered a reservation to retain the primacy of its domestic rules applying to the taxation of insurance by excluding the taxation of insurers from the scope of Article 7. This allows New Zealand to tax premiums derived by non-resident insurers in respect of New Zealand risks despite the absence of a permanent establishment (PE) in New Zealand. This reservation has been incorporated into 36 of the 37 DTAs New Zealand has negotiated. The Swiss DTA is the one exception.<sup>6</sup> This exclusion of insurance is usually achieved by a separate clause in Article 7 or in an attached protocol negotiated at the same time as the DTA. The latter is more commonly found with DTAs negotiated with other OECD members.

Another area where there is a departure from the text of the OECD Model, reflecting a reservation New Zealand has entered,<sup>7</sup> is a provision to cover profits derived by a beneficiary of a trust from a business carried on by the trustee through a PE in the other contracting state.<sup>8</sup> The provision is essentially a "look-through" and deems the beneficiary to derive income from that PE despite it being earned by the trustee.

New Zealand has also entered a reservation in respect of Article 8 (Transport) concerning domestic transport. Many of New Zealand's DTAs include an additional paragraph in Article 8 allowing a contracting state to tax a transport operator from the other state if they carry goods or traffic between two domestic points in the first state. This is important to New Zealand as it permits foreign ships to upload and discharge cargo between New Zealand ports. New Zealand also permits foreign airlines to similarly carry traffic between two New Zealand airports in some situations.

In respect of Article 12, New Zealand has reserved the right to tax royalties at source and not to exempt them. It has also reserved the right to include within the definition of 'royalty' payments for the leasing of industrial, commercial or scientific equipment and of containers, and not to follow the deletion of these activities from the royalty definition arising from the 1992 revision of the OECD Model. As consequence, a large

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<sup>6</sup> Under section CR 3(3) *Income Tax Act 2007* (NZ) (ITA), non-resident general insurers are taxed on a deemed basis, with their net income being deemed to be 10 percent of the gross premiums sourced from New Zealand.

<sup>7</sup> Commentary on *OECD Model Tax Convention on Income and on Capital*, (2008, OECD, Paris) Article 7 [76]. Australia has also entered a reservation on the same point.

<sup>8</sup> Found in the DTAs with Australia (2009) in Article 7(7); Singapore (2009) in Article 7(6); Thailand in Article 7(7).

proportion of New Zealand's DTAs still include equipment leasing within the royalty definition.<sup>9</sup>

New Zealand has also entered a reservation to Article 14 (deleted from the OECD Model in 2000) which has resulted in departures from the text of the OECD Model in its DTAs. The independent services article in New Zealand's DTAs usually allows professional services to be taxed where the provider is present in the state for more than 183 days in any 12 month period even though they do not have a fixed base available to them.<sup>10</sup> This 183 day/12 month rule was not found in Article 14 of the OECD Model Convention prior to its deletion in 2000 but was noted in a reservation New Zealand had to that Article.

New Zealand has also reserved its position to the non-discrimination article in the OECD Model. Approximately half New Zealand's DTAs do not contain such an article. In those that do, there are often significant departures from the text of Article 24 from the OECD Model. The second sentence from Article 24(3) of the OECD Model Convention referring to personal reliefs and grants is omitted from paragraph (3) and is usually shifted to a stand-alone paragraph. This means that the exclusions for personal reliefs and grants are not limited to just PEs but apply in respect of all matters (including, for example, employment income).

The equivalent of Article 24(5) in New Zealand's DTAs usually contains a major variation which substantially restricts the way in which the non-discrimination article applies to associated enterprises.<sup>11</sup> Article 25(5) of the OECD Model Convention prevents a contracting state from imposing any requirement which is other or more burdensome on enterprises of a contracting state which are controlled by residents of the other contracting state in comparison to similar enterprises of the first state. In the New Zealand DTAs, the restriction is not in terms of the requirements imposed on locally controlled enterprises vis-à-vis non-resident controlled ones but instead when compared to enterprises controlled by residents of third states. Thus Article 24(5) in New Zealand's DTAs becomes more of a "most favoured nation" clause.

In the other direction, several OECD members have entered reservations to Article 9(2) of the OECD Model which requires a contracting state to make compensating adjustments where the other state has made a transfer pricing adjustment pursuant to Article 9. A number of New Zealand's DTAs do not have Article 9(2) included, with nearly all being OECD members that have entered a reservation to that paragraph in the Commentaries.<sup>12</sup>

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<sup>9</sup> The two exceptions being the 2009 DTA with Australia and the 1983 DTA with the US due to revisions from the 2008 protocol.

<sup>10</sup> DTAs with India, Indonesia, Ireland, Norway, Philippines, Russia, Sweden, Taiwan, Thailand, Turkey, United Arab Emirates (UAE), UK and the US.

<sup>11</sup> The variation appears in the DTAs with Austria, Belgium, Chile, Denmark, Mexico, Netherlands, Poland, Russia, South Africa, Spain, Thailand and Turkey.

<sup>12</sup> For example, DTAs with Belgium, Finland, France, Germany, Indonesia, Italy, Korea, Norway, Sweden, Switzerland and the UK.

### ***C Differences of a Minor Nature***

The computer-based text comparison shows that some of New Zealand's DTAs contain text which has been changed to a minor degree from the OECD Model Convention but not in a way that changes the meaning of that article in any substantial way. In a number of New Zealand's newer DTAs this has occurred because New Zealand has a policy of adopting gender-free wording in its legislation while the OECD Model Convention contains wording in the masculine gender.<sup>13</sup> Another reason for these minor changes in wording is to adopt terminology found in one or both of the contracting states' domestic law rather than the terms used in the OECD Model Convention. The OECD Model Convention also employs terminology in some parts reflecting civil code legal systems (that is, "immovable property") when New Zealand's legal system is based on common law which may use different terminology.<sup>14</sup>

One article which appears to have undergone a significant redrafting from the one from the OECD Model, but often not resulting in any substantial difference, is Article 23 (Methods for Elimination of Double Taxation). The wording found in Article 23 in virtually all of New Zealand's DTAs does not follow the OECD Model. The OECD Model has generic provisions (for either exemptions or foreign tax credits) which apply to both contracting states. New Zealand's DTAs usually have separate paragraphs for each contracting state even though in most DTAs both states agree to reciprocally grant foreign tax credits. The adoption of non-OECD wording appears to have been to reflect specific features of each contracting states' domestic law regarding foreign tax credits.

### ***D Alternative Drafting Options from the Commentaries***

There are a number of instances in New Zealand's DTAs where the text departs from that of the OECD Model but the text adopted is from an alternative set out in the Commentaries to that article. For example, in about half of New Zealand's DTAs, Article 8(1) has been amended so that the basis for taxing transport enterprises is not based on the place of "effective management", but merely specifies "enterprises from one contracting state". This variation is suggested as an alternative in paragraph 2 in the Commentaries on Article 8.

Another example can be found in the definition of interest from Article 11(3). New Zealand's DTAs almost always include a clause to the effect that interest includes income treated as income (or assimilated to income) from money lent by the laws, relating to tax, of the Contracting State in which the income arises. This would permit reclassification of lease payments in respect of a finance lease as interest where in the absence of this wording it could be difficult to sustain.<sup>15</sup> This issue is discussed in paragraph 21 of the OECD Commentary on Article 11.

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<sup>13</sup> See G Hunt, 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14(2) *New Zealand Journal of Taxation Law and Policy* 131, 150.

<sup>14</sup> *Ibid* 155-6.

<sup>15</sup> Refer to: Austria DTA Article 11(4), Chile DTA Article 11(3), Czech Republic DTA Article 11(4), Ireland DTA Article 13(3), Italy DTA Article 11(4), Korea DTA Article 11(4), Mexico DTA Article 11(4), Philippines DTA Article 11(3), Poland DTA Article 11(3), Russian Federation DTA Article 11(3), South



In 2000 the OECD Model was revised and Article 14 covering independent personal services was deleted. A number of New Zealand's DTAs negotiated since 2000 have followed this deletion and excluded an equivalent to the earlier Article 14.<sup>16</sup> However, specific reference to such activities has usually been shifted to Article 5 in the definition of "permanent establishment", deeming a PE to arise when professional services are provided using a 183 day/12 month rule similar to that found in Article 14 in earlier DTAs. This has been done by adopting alternative wording from the Commentaries in paragraph 42.23 in respect of Article 5.

### ***E Reversing Unfavourable Court Interpretations***

Another reason for a departure from the text of the OECD Model Convention is to overcome an unfavourable interpretation by a court of an article from the OECD Model. A number of New Zealand's more recently negotiated DTAs include a minor but significant variation to Article 15(2)(c) applying to the taxation of dependent personal services.<sup>17</sup> In the OECD Model Convention the paragraph reads "the remuneration is not *borne* by a permanent establishment..." while in a number of New Zealand DTAs this has been changed to:

"the remuneration is not *deductible* in determining the taxable profits of a permanent establishment".

This revised wording reflects a change in New Zealand's negotiating position as a result of a case *CIR v JFP Energy Inc.*<sup>18</sup> This case concerned the New Zealand taxation of non-resident employees employed by a non-resident oil exploration company while they worked on their employer's oil exploration rig in New Zealand waters drilling for oil. The taxpayer did not charge the salaries of these employees against its New Zealand branch (PE) income in tax returns filed in New Zealand. The CIR contended that New Zealand was entitled to tax the remuneration of these employees under Article 15 of the US DTA as the remuneration was borne by a PE in New Zealand even though no deduction had been sought in New Zealand against the PE's income. The New Zealand Court of Appeal held that because their remuneration had not been deducted against their employer's New Zealand branch income, it had not been borne by a PE in New Zealand and therefore the remuneration paid to these employees was not taxable in New Zealand but solely in the US.

The revised wording New Zealand has adopted in Article 15(2)(c) effectively establishes a nexus test according to whether the employee remuneration would qualify for a deduction against the income of a PE, irrespective of whether a deduction has been claimed or sought by the taxpayer. This revised wording is also consistent with the

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Africa DTA Article 11(4), Spain DTA Article 11(4), Taiwan DTA Article 11(3), Thailand DTA Article 11(4), and UAE DTA Article 12(5).

<sup>16</sup> These include the DTAs with Australia (2009), Chile, Czech Republic, Mexico, Poland, Singapore (2009), South Africa and Spain. This is an area where the OECD Model Convention and UN Model Convention differ, and New Zealand has followed the UN Model Convention.

<sup>17</sup> See the DTAs with Australia, Austria, Czech Republic, Mexico, Philippines, Singapore (2009), South Africa, Spain, Thailand, Turkey and the UAE. The DTA with Norway uses the word "connected with" instead of "borne by".

<sup>18</sup> (1990) 12 NZTC 7,176 (CA).

revisions to Commentaries on Article 15, paragraph 2 made in 2000 which clarified what the phrase “borne by” means.<sup>19</sup>

It is also interesting to note that several countries (Ireland, Norway and the UK) have entered a reservation to Article 15 to reserve the right to insert “special article provisions regarding income derived from employment relating to offshore hydrocarbon exploration and exploitation and related activities”.<sup>20</sup> This is clearly to address the same concerns that New Zealand had from the *JFP Energy* case.

### ***F Retention of Features from Earlier Versions of the OECD Model***

Revisions to the OECD Model have not always met with New Zealand’s approval. In 2000 the OECD Model was revised and Article 14 applying to independent personal services was deleted. A number of New Zealand’s DTAs negotiated since 2000 have followed this revision and excluded the equivalent to Article 14.<sup>21</sup> However, specific reference to such activities has been shifted to Article 5 in the definition of “permanent establishment”, deeming a PE to arise when professional services are provided under a 183 day/12 month rule comparable to that found in earlier DTAs with an independent services article (Article 14). This suggests that New Zealand was not comfortable with the deletion of Article 14 from the OECD Model Convention in 2000, and therefore has effectively retained the provisions of the old Article 14 in its more recently negotiated DTAs. This treatment is also consistent with an option discussed in the revised Commentaries to Article 5.

An area where this will arise in future is in respect of Article 7 (Business Profits). Article 7 underwent a major revision in the 2010 update of the OECD Model; however, New Zealand has entered a reservation to the new version of Article 7 to retain the right to use the previous version of Article 7 taking into account its observations and reservations on that previous version. This is because New Zealand “does not agree with the approach reflected in Part I of the 2010 [OECD] Report *Attribution of Profits to Permanent Establishments*”.<sup>22</sup>

### ***G Clarification and Enhancement of Articles from the OECD Model***

A feature of many of New Zealand’s DTAs is the inclusion of additional paragraphs in Articles based on ones from the OECD Model. Some of these incorporate discussion from the Commentaries into the DTA to reduce or eliminate ambiguity in the interpretation of an article. In other parts these additions provide greater clarity as to how New Zealand and the other contracting state will apply that article.

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<sup>19</sup> Commentary on *OECD Model Tax Convention on Income and on Capital* (2008, OECD, Paris) Article 15 [7].

<sup>20</sup> *Ibid.*

<sup>21</sup> These include the DTAs with Australia (2009), Chile, Czech Republic, Mexico, Poland, Singapore (2009), South Africa and Spain. This is an area where the OECD Model Convention and UN Model Convention differ, and New Zealand has followed the UN Model Convention.

<sup>22</sup> OECD, *Model Tax Convention on Income and on Capital -Condensed Version 2010*, Paris, France, July 2010, 153 [95].

In Article 5(3) a number of New Zealand's DTAs include an anti-avoidance provision to prevent the splitting of a large construction contract between associated parties so that each part is of less than 6 or 12 months duration.<sup>23</sup> This issue is discussed in paragraph 18 in the Commentaries to Article 5(3) although no definitive solution to this issue is advanced in the Commentaries.

Many of New Zealand's DTAs also include in Article 5 an additional provision covering supervisory activities that are related to construction projects and where substantial equipment or machinery is used for more than 12 months in a contracting state. Article 5(5) from the NZ-Finland DTA is typical of this provision:

5. An enterprise of a Contracting State shall be deemed to have a permanent establishment in the other Contracting State if:
  - a) it carries on supervisory activities in that other State for more than twelve months in connection with a construction, installation or assembly project which is being undertaken in that State; or
  - b) substantial equipment or machinery is for more than twelve months in that other State being used by, for or under contract with the enterprise.

Some of New Zealand's DTAs also contain specific provisions in Article 5 to ensure that natural resource exploration and exploitation activities constitute a PE. This is an important issue to New Zealand in respect of offshore oil exploration and development.

While Article 9 from the OECD Model has only two paragraphs, some of New Zealand's DTAs have an additional paragraph in this Article, which allows for the use of default assessment methods should there be inadequate information available for a transfer pricing review, and some have time limits upon how far retrospective tax audits may go. These are more commonly found in DTAs with non-OECD members, although Article 9(2) and 9(4) from the Australian DTA and Canadian DTA respectively, are good examples of these provisions despite these states being OECD members.

In some DTAs Article 17 has an additional paragraph which exempts certain Government sponsored or paid individuals or ones sponsored by non-profit bodies. A number of these additional paragraphs are similar to the provision suggested in paragraph 14 in the Commentaries on this Article for this purpose. Several DTAs also have in Article 17 a provision which permits a "look-through" for companies who employ entertainers.

A common feature in Article 23, in the paragraph requiring New Zealand to grant foreign tax credits for tax paid in the other contracting state, is a clause which specifically excludes New Zealand from having to grant foreign tax credits for underlying corporate tax paid on income from which dividends were paid. This

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<sup>23</sup> This anti-avoidance provision is found in the DTAs with Australia, Austria (protocol), Chile, Mexico, Poland, Russia (protocol), Singapore (2009), South Africa, Spain, Taiwan, Thailand and Turkey (protocol). Similar anti-avoidance provisions, but with more limited scope, appear in the DTAs with China, Indonesia (protocol) and the US.

provision appears to have been inserted at New Zealand's instigation to clarify that New Zealand has no obligation to grant foreign tax credits for underlying foreign tax paid on company income.

Another area where additional provisions are found for the purposes of clarification is in non-discrimination articles. The New Zealand DTAs that do incorporate a non-discrimination article usually include a paragraph to make it clear that anti-avoidance provisions targeted at non-residents only (such as transfer pricing and thin capitalisation rules) are not discriminatory in terms of the article. Article 25(5) from the Finnish DTA is illustrative of this type of exclusion:

- (5) This Article shall not apply to any provision of the taxation law of a Contracting State which:
- a) is reasonably designed to prevent or defeat the avoidance or evasion of taxes which is in force on the date of signature of this Convention; or
  - b) is substantially similar in general purpose or intent to any such provision but is enacted after that date; provided that any such provision (except where that provision is in an international agreement) does not allow for different treatment of residents or nationals of the other Contracting State as compared with the treatment of residents or nationals of any third state.

### ***H Articles Where the OECD Model has no Equivalent***

New Zealand and Australia both levy a special tax on employers (known as "fringe benefit tax") if they provide fringe benefits to their employees. In New Zealand this tax is imposed under the relevant *Income Tax Act* while in Australia it is imposed as a separate tax. The 1995 and 2009 DTAs with Australia contain an article to deal with this tax which has no equivalent in the OECD Model.<sup>24</sup>

New Zealand does not impose any tax on capital. Consequently, none of New Zealand's DTAs include an article equivalent to Article 22 from the OECD Model concerning the taxation of capital.

## **VI EFFECTS OF THE OECD MODEL UPON NEW ZEALAND'S INTERNATIONAL TAX POLICY**

New Zealand's accession to the OECD has not only led to it expanding its DTA network and basing its DTA negotiations upon the OECD Model, but also to changes in its international tax policy. Prior to joining the OECD, New Zealand had negotiated only eleven DTAs with nine countries in a period of nearly thirty years. It was reluctant to negotiate DTAs because it felt it would have to concede source taxing rights found in its domestic law and also that model agreements used for DTA negotiations favoured capital exporting countries. The former had been experienced with its DTA negotiations in the 1950s and 1960s, when negotiations had sometimes faltered due to its reluctance

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<sup>24</sup> Article 15, Australian DTA (2009).

to concede source taxing rights (that is, royalties with Germany), or when agreement was only reached after it made concessions (shipping with Japan).<sup>25</sup>

New Zealand was well aware that by joining the OECD it would have to extend its DTA network. It would have to restart negotiations with a number of European countries when decade's earlier negotiations had stalled because of New Zealand's reluctance to concede source taxation of income such as royalties and dividends. When New Zealand analysed the 1977 OECD Model to determine the observations and reservations it would enter to that Model, it felt as a new member of the OECD it could not enter an excessively large number of observations and reservations. It had to prioritise which matters it wanted to enter reservations about so that the overall number would be acceptable to other OECD members.

In respect of some of the matters New Zealand has entered reservations to, it has been reasonably successful at maintaining them in subsequent DTA negotiations. It has retained the right to tax royalties at source and, until very recently, the right for all dividends to be taxed at 15 percent without a lower rate for parent-subsidiary ones. With one exception, it has been successful in maintaining its domestic rules for taxing non-resident insurers, enabling them to be taxed in the absence of a PE.

It has been less successful at maintaining its reservation about the inclusion of non-discrimination articles. However, in this regard it should be noted that those New Zealand DTAs that do include such an article often contain provisions markedly different to those of the OECD Model which significantly reduces these articles' scope.<sup>26</sup> Therefore it can be concluded that New Zealand has perhaps been more effective in upholding its reservation to non-discrimination articles than initial observations would suggest.

The same cannot be said for equipment leasing. New Zealand has been much less consistent at maintaining its right to tax the leasing of scientific, industrial and commercial equipment within the royalty article. Some New Zealand DTAs contain protocols which subsequently shift such leasing to Article 7 meaning that non-resident lessors are not liable to tax in New Zealand unless they have a PE there. Only the recently negotiated Australian DTA and the protocol to amend the US DTA exclude equipment leasing from the definition of a royalty article, bringing them into line with the definition found in the OECD Model.

Since 2008 New Zealand has concluded four treaties which contain some significant differences compared to earlier DTAs. These four DTAs comprise three new DTAs negotiated with Australia, Singapore and Hong Kong, plus a substantial protocol with the US to amend the 1983 DTA with that country. These differences are as follows:

- Inter-company dividends where there is a shareholding of 10 percent or more are now subject to a maximum of 5 percent withholding tax in the source country.

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<sup>25</sup> See A Smith, 'A History of New Zealand's Double Tax Agreements', (2010) 16(1) *New Zealand Journal of Taxation Law and Policy* 105, 111, 113; Hunt, above n 13, 145.

<sup>26</sup> Hunt, above n 13, 166.

- Under the US and Australian DTAs, where a corporate shareholding interest is 80 percent or greater, inter-company dividends are exempt from withholding tax subject to a limitation of benefit provision.
- Royalties are subject to a maximum of 5 percent withholding tax in the source country.
- Certain cross-border payments of interest are exempt from tax in the source country although in some cases this is linked to the payment of AIL by the New Zealand borrower.
- Leasing of scientific, commercial and industrial equipment has been removed from the definition of 'royalty' in the US and Australian DTAs.

What has led New Zealand to agree to lower withholding tax rates for interest, dividends and royalties in these DTAs after resisting lower rates in its DTA negotiations for over 50 years? No explicit reason was given by the Minister of Revenue when announcing that negotiations for these new DTAs had been successfully concluded.

In some cases the reductions in withholding tax in these four new treaties merely reflect unilateral reductions New Zealand had already made in the taxation of non-residents with introduction of the Approved Issuer Levy (AIL) and Foreign Investor Tax Credit (FITC) rules. These reduced withholding tax rates on interest and dividends in DTAs merely ensured a reciprocal reduction for New Zealand investors that had already been made unilaterally to non-resident ones earlier.

Some further explanation can be seen, however, in a discussion document published in 2006 titled *New Zealand's International Tax Review: A direction for change*, containing proposals for revised CFC rules.<sup>27</sup> In this document it was suggested that New Zealand's existing CFC rules (which were extremely comprehensive) had indirectly contributed to New Zealand's poor export performance and also encouraged corporate/capital migration, therefore requiring reform. The reforms proposed in the discussion document to introduce an active-passive exemption in New Zealand's CFC rules would result in active income earned offshore by New Zealand businesses no longer being taxed on an accrued basis, but instead becoming exempt from New Zealand tax.

By bringing New Zealand's international tax rules "into line with international norms" it was intended to reduce the barriers faced by New Zealand-based firms under current tax rules and enable them to exploit the benefits of operating internationally. Competitiveness with Australia was seen to be particularly critical:

"It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia."<sup>28</sup>

The same discussion document also examined possible changes to New Zealand's DTA policy by reducing withholding tax rates as a further way of reducing barriers to

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<sup>27</sup> Rt Hon Michael Cullen and Hon Peter Dunne, *New Zealand's International Tax Review: A direction for change*, (Policy Advice Division, Inland Revenue Department, Wellington, December 2006) 1 [1.5], 3 [1.13-1.14].

<sup>28</sup> *Ibid* 1 [1.3].



offshore investment to assist with the internationalisation of New Zealand businesses.<sup>29</sup> This partly reflected concerns about the advantages Australian companies had gained when Australia renegotiated its US DTA in 2002, resulting in lower withholding tax rates on passive income. Thus by New Zealand revising its DTA policy for lower withholding tax rates on passive income, this would improve the international competitiveness of New Zealand businesses, especially with respect to Australian firms.

But from a broader perspective, New Zealand is now recognising that, while being a net capital importer, it is also a capital exporter. Therefore reductions in withholding tax rates are not necessarily against its interests when it is done reciprocally under a DTA.

## VII CONCLUSION

The use of computerised text comparison provides a useful insight into the influence of the OECD Model on the DTAs New Zealand has negotiated. The results obtained show that OECD membership had had a pronounced effect upon New Zealand's DTA negotiations leading to a network of 37 DTAs at the end of 2010, most of which are based upon the OECD Model. The influence of the OECD Model upon New Zealand's DTAs only became apparent after it joined the OECD and entered its reservations to the 1977 version of the OECD Model. DTAs negotiated by New Zealand prior to this date have little in common with the OECD Model. The convergence of the content in New Zealand's DTAs is also apparent through its use of the OECD Model, especially the 1977 Model, following New Zealand's accession to the OECD. Even so, many of New Zealand's DTAs still differ from the OECD Model in a number of areas. These differences have typically arisen to protect New Zealand's source taxing rights in some areas but also to resolve ambiguity and to place less reliance upon the Commentaries in defining the scope of some articles.

There is evidence that in more recent times OECD membership has also influenced New Zealand's international tax policy. New Zealand has gradually conceded a number of earlier 'sticking points' in its international tax policy, many of which were prevalent in negotiating its early DTAs prior to accession to the OECD, so as to become more convergent with OECD norms. Such a finding should not be a surprise given the growing influence of globalisation on tax policy, the increasing size, number and powers of multinational enterprises, the need to combat international tax avoidance and evasion, and the increasing reliance on international trade and investment by nations. This influence has also been consistent with the direction of New Zealand's economic reforms since the mid 1980s, enabling it to become one of the most economically liberal nations globally in terms of the freedoms for flows of investment and trade even although it remains a net capital importer.

Overall it appears the OECD Model has not only assisted New Zealand in concluding its DTA negotiations but also enabled it to enjoy the benefits flowing from the international acceptance of the Commentaries as a tool for interpretation of DTAs as well as international cooperation in tax administration.

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<sup>29</sup> Ibid 2 [1.8].

**GIVEN THE FACT THAT AUSTRALIA HAS HAD A 'PETROLEUM RESOURCE RENT TAX' SINCE 1987, WHY SHOULD THERE BE ANY OPPOSITION TO A 'MINERAL RESOURCE RENT TAX'?**

JOHN MCLAREN AND PIERRE CHABAL\*

**ABSTRACT**

The Australian Government introduced a resource rent tax on offshore oil and gas deposits in 1987 and since then it has raised in excess of an additional \$1 billion a year in revenue over and above the normal company tax on income. At the time it was being introduced a great deal of controversy followed the proposed introduction of the petroleum resource rent tax (PRRT). On 2 November 2011, the Australian government introduced the raft of bills into Parliament for the imposition of a Mineral Resource Rent Tax (MRRT) on profit generated from iron ore, coal and gas from coal seams from 1 July 2012. Onshore oil and gas deposits will now be subject to a rent tax under the new PRRT regime that was also introduced into Parliament on 2 November 2011. The proposed MRRT has been met with criticism from certain mining companies, the Opposition parliamentary parties and noted economists. However, Australia currently has a budget deficit and a MRRT is being viewed by the government as being a solution to repaying government debt and to redistribute the burden of tax by reducing the rate at which companies pay income tax. A Resource Rent Tax (RRT) has been used by a number of countries such as the United Kingdom and Norway to increase government revenue from their 'North Sea' oil reserves. This paper will address the question raised above: namely, why is there opposition to a proposed MRRT given the continued existence of a PRRT in Australia for over 14 years? The paper will also contend that there are sound philosophical reasons for having this form of taxation and that as a result of the continued existence of a PRRT in Australia together with the fact that resource rent taxes have been adopted in many other countries, that the criticism of the new MRRT is unwarranted.

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## I INTRODUCTION

The paper will start with a discussion of the political implications that followed from the proposal of the Australian Government to introduce a MRRT. This will be followed by an examination of the current resource rent tax regimes in use by different governments in other countries. This examination of the existing resource rent taxes that are being imposed in other countries is limited in its scope but it is included in this paper to illustrate the fact that resource rent taxes have been accepted by mining companies in other jurisdictions for many years. From this perspective, it will be contended that the opposition to a MRRT by the mining companies in Australia is grossly hypocritical given the fact that this form of taxation is accepted globally. The second part of the paper will commence with a discussion of the philosophical basis for the imposition of an extra tax on the cash flow profit from minerals. This part of the paper will examine the current PRRT and the new PRRT Bill as well as a discussion of the final MRRT Bill that was introduced into the Australian Parliament on 2 November 2011. The third part of the paper will then critically examine the criticisms from various parties to the MRRT in order to determine whether or not these purported defects in the tax have merit and should be taken into account by the government. Finally, the conclusion will provide an answer as to the merit of the various criticisms and a prognosis as to the future of mineral taxes in Australia.

The renewed interest in a resource rent tax on mining was the initiative of Dr Ken Henry and the members of the review into 'Australia's Future Tax System', now commonly referred to as the 'Henry Review'.<sup>1</sup> The review recommended the introduction of a resource rent tax for all mineral and petroleum resources except brown coal.<sup>2</sup> In the final report, Henry contended that the royalty system, which allows the states to collect revenue based on the value of the resource being sold and the volume of output, should be replaced by a resource rent tax.<sup>3</sup> As a result of this review, the Government announced on 2 May 2010 that they would introduce a 'Resource Super Profits Tax' on mining to not only generate additional revenue but compensate a reduction in the rate of company tax to ultimately 28 percent. The Government also proposed that there would be an increase in the Superannuation Guarantee Charge to 12 percent and finally to provide funds for an investment in infrastructure that would benefit future generations of Australian residents.<sup>4</sup>

The super profits tax was set at a rate of 40 percent and was to apply from 1 July 2011.<sup>5</sup> However, as a result of a campaign against the tax by the mining industry, the Opposition Party in Parliament and public opinion, the incumbent Prime Minister Kevin Rudd was replaced by Julia Gillard on 24 June 2010.

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<sup>1</sup> Australia's Future Tax System Review Panel (K Henry (Chair), J Harmer, J Piggott, H Ridout and G Smith), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (AFTS Report).

<sup>2</sup> Ibid 217.

<sup>3</sup> Ibid.

<sup>4</sup> The Treasurer, Wayne Swan, 'Stronger, Fairer, Simpler: A Tax Plan for our Future' (Press Release, No. 028, 2 May 2010),

<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/028.htm&pageID=003&min=wms&Year=2010&DocType=0>

<sup>5</sup> Ibid.

The new Prime Minister, Julia Gillard then negotiated a new form of resource rent tax to be applied to mining companies extracting iron ore, coal and coal seam gas only. The end result was a new 'Minerals Resource Rent Tax Bill' (MRRT) and Exposure Draft that was released for public comment on 18 September 2011. Prior to this happening, the Australian Government had formed a 'Policy Transition Group' made up of resource sector, government and taxation experts to provide advice on the design and implementation of a MRRT.<sup>6</sup> On 24 March 2011, the Policy Transition Group reported to the Government on its findings. The Government accepted all 98 recommendations of the Policy Transition Group, led by Resources Minister Martin Ferguson and Mr. Don Argus AC, relating to the new resource tax arrangements. The recommendations form the basis of the second draft MRRT legislation. Consultation on the exposure draft closed on 5 October 2011.

### ***A The MRRT System***

The final raft of legislation creating the MRRT and amending the PRRT was introduced into Parliament on 2 November 2011.<sup>7</sup> The object of the MRRT Bill is stated in section 1-10 as follows:

The object of this Act is to ensure that the Australian community receives an adequate return for its taxable resources, having regard to:

- a) the inherent value of the resources; and
- b) the non-renewable nature of the resources; and
- c) the extent to which the resources are subject to Commonwealth, State and Territory royalties.

This Act does this by taxing above normal profits made by miners (also known as economic rents) that are reasonably attributable to the resources in the form and place they were in when extracted.

A 'taxable resource' is defined in Division 20 of the Bill as coal, iron ore and coal seam gas. The Government's objective for the introduction of the MRRT legislation will be discussed in Part II of the paper when the philosophical basis for a resource rent tax is examined.

The MRRT is based on taxing projects, similar to the PRRT. Mining projects that do not generate resource profits of more than AUD 50 million in a given year will not be subject to the MRRT. This is designed to reduce the compliance costs for small mining companies.<sup>8</sup>

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<sup>6</sup> Australian Government Policy Transitions Group, *Issues Paper: Technical Design of the Minerals Resource Rent Tax, Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and Policies to Promote Exploration Expenditure*, 1 October 2010.

<sup>7</sup> Minerals Resource Rent Tax Bill 2011, Minerals Resource Rent Tax (Consequential Amendments and Transitional Provisions) Bill 2011, Minerals Resource Rent Tax (Imposition–Customs) Bill 2011, Minerals Resource Rent Tax (Imposition–Excise) Bill 2011, and Minerals Resource Rent Tax (Imposition–General) Bill 2011 <[www.aph.gov.au](http://www.aph.gov.au)> at 3 November 2011.

<sup>8</sup> Australian Government Policy Transitions Group, above n 6, 67.

The MRRT is imposed at a rate of 30 percent and not 40 percent which is the current rate of tax under the PRRT. The profit or loss calculation is based on the assessable receipts less deductible expenditure less the uplift carry forward losses. The uplift factor is the long term bond rate plus 7 percent.<sup>9</sup>

The MRRT will be a deductible expense when calculating taxable income for income tax purposes. This is the current situation under the PRRT where the PRRT is a deduction against assessable income pursuant to s 44-750, *Income Tax Assessment Act 1997* (Cth). Royalties paid to the states and the Northern Territory will be credited against any MRRT liability and any excess royalty payments will be uplifted and applied against future MRRT liabilities. Any excess royalty payments will not be refundable.<sup>10</sup> The MRRT will only apply to iron ore, coal and petroleum projects. It will also apply to coal seam methane or technologies that will convert coal into petroleum products. It will not apply to other minerals.<sup>11</sup> The MRRT will apply from 1 July 2012 but the market value of assets acquired for projects after 1 May 2010 will be included in the expenditure calculation for the MRRT.<sup>12</sup>

The Explanatory Memorandum provides the following outline and financial impact summary of how the tax will operate:

The Minerals Resource Rent Tax (MRRT) is a tax on the economic rents miners make from the taxable resources (iron ore, coal and some gases) after they are extracted from the ground but before they undergo any significant processing or value add. 'Economic rent' is the return in excess of what is needed to attract and retain factors of production in the production process.

The MRRT is a project-based tax, so a liability is worked out separately for each project the miner has at the end of each MRRT year. The miner's liability for that year is the sum of those project liabilities. The tax is imposed on a miner's mining profit, less its MRRT allowances, at a rate of 22.5 per cent (that is, at a nominal rate of 30 per cent, less a one-quarter extraction allowance to recognise the miner's employment of specialist skills).

A project's mining profit is its mining revenue less its mining expenditure. If the expenditure exceeds the revenue, the project has a mining loss. Mining revenue is, in general, the part of what the miner sells its taxable resources for that is attributable to the resources in the condition and location they were in just after extraction (the 'valuation point'). Mining revenue also includes recoupments of some amounts that have previously been allowed as mining expenditure.

Mining expenditure is the cost a miner incurs in bringing the taxable resources to the valuation point. Mining allowances reduce each project's mining profit. The most significant of the allowances is for mining royalties the miner pays to the States and Territories. It ensures that the royalties and the MRRT do not double tax the mining profit. In the early years of the MRRT, the project's starting base provides another important allowance. The starting base is an amount to recognise the value of investments the miner has made before the MRRT.

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<sup>9</sup> Ibid 8.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid 11.

<sup>12</sup> Ibid 95.

Other allowances include losses the project made in earlier years and losses transferred from the miner's other projects (or from the projects of some associated entities). If a miner's total mining profit from all its projects comes to less than \$50 million in a year, there is a low-profit offset that reduces the miner's liability for MRRT to nil. The offset phases out for mining profits totalling more than \$50 million.

The MRRT is expected to generate revenue of \$3.7 billion in 2012-13; \$4 billion in 2013-14; and \$3.4 billion in 2014-15.<sup>13</sup>

### ***B Resource Rent Taxes in Other Countries***

Many countries impose additional taxes on mining companies selling petroleum and mineral resources that have been extracted from their land. Given this situation, why then should there be reluctance on the part of mining companies to accept a MRRT in Australia which will only apply to coal, iron ore and coal seam gas? The following examination is very limited in its scope of the resource rent regimes adopted in other countries but it does show that this form of taxation of mineral resources has been used elsewhere, thus supporting the argument that it perhaps should not be subject to criticism in Australia.

Many countries have imposed a resource rent tax on petroleum and mineral extraction projects. Australia was one of the first countries to introduce a RRT in 1984, but Papua New Guinea (PNG) had already introduced a RRT in 1977 on petroleum projects and then in 1978, on mining projects. PNG subsequently removed the RRT in 2002 on mining and introduced a progressive profits tax.<sup>14</sup> In 1984, Ghana and Tanzania also introduced a RRT.<sup>15</sup> Since then, many countries have either contracted with mining companies to impose a RRT on profit or legislated to impose the RRT. Russia introduced a RRT in 1994; Kazakhstan in the mid-1990s; Angola in 1996; British Columbia in Canada in 1990; Namibia in 1993; and Timor-Leste in 2006; to name just a few.<sup>16</sup>

Both the United Kingdom (UK) and Norway impose a resource rent tax on petroleum profits derived from the North Sea on the 'Continental Shelf'. The UK first introduced a petroleum resource tax when the North Shelf was first developed in 1975. Since then it has been amended and altered a number of times.<sup>17</sup> The UK and Norway abolished royalties based on the value of oil and gas extracted in 2002 and 1986 respectively.<sup>18</sup> The reason given for abolishing royalties was that it was a regressive tax as it applied to gross revenue and acted as a disincentive to exploration and production.<sup>19</sup> The UK applies a petroleum rent tax (PRT) at the rate of 50 percent as well as the normal company income tax. Norway applies a special petroleum tax (SPT) at 50 percent and the normal company tax on income.<sup>20</sup> The UK government imposed a supplementary

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<sup>13</sup> Explanatory Memorandum, Mineral Resource Rent Tax Bill 2011 (Cth) 3.

<sup>14</sup> J. Sarma and G Naresh, 'Mineral Taxation around the World: Trends and Issues' (2001) January, *Asia-Pacific Tax Bulletin* 2, 7.

<sup>15</sup> Bryan Land, 'Chapter 8-Resources rent taxes', in Philip Daniel, Michael Keen and Charles McPherson (eds) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (Routledge, 2010) 243

<sup>16</sup> *Ibid*

<sup>17</sup> Carole Nakhle, 'Can the North Sea still save Europe?' (2008) *OPEC Energy Review* 123, 134.

<sup>18</sup> *Ibid* 133.

<sup>19</sup> *Ibid*.

<sup>20</sup> *Ibid*.

charge of a further 10 percent in 2002 and in 2005 increased the rate to 20 percent on the company income. However, the PRT is deductible for income tax purposes. Norway does not allow the SPT to be deductible for income tax purposes and the effective marginal tax rate on the income of the company is 78 percent.<sup>21</sup>

The UK system is complicated by the fact that the PRT is based on the development of the oil fields and especially those fields given development consent before 1993 and those given consent after 1993. In the former case, fields that received permission before 1993 are taxed on their income at a company tax rate of 50 percent and a PRT at the rate of 50 percent whereas the later fields are subject only to a company tax rate of 50 percent.<sup>22</sup> In 2002 the UK government introduced a 10 percent supplementary charge on the same basis as company tax but there was no deduction for financing costs against the supplementary charge.<sup>23</sup> The royalty was abolished on older fields that had received development consent before 1983 in an attempt to encourage fuller exploitation of reserves from those fields.<sup>24</sup> In 2005 in light of an increase in oil prices the UK government doubled the supplementary charge to 20 percent.<sup>25</sup> This means that in the UK oil and gas is taxed at the highest rate of any industry: for fields given approval after 1983, a company tax rate of 30 percent and the supplementary charge of 20 percent. For those fields given approval prior to 1983, the marginal rate of tax is 75 percent and they are also liable to company tax at the rate of 50 percent.<sup>26</sup>

Zambia nationalized its copper industry in 1964 but this was later repealed in 1985. Since then the government has imposed a royalty rate of 3 percent, a variable income tax rate and a windfall tax applied to the value of production. However, in 2009 the windfall tax was repealed.<sup>27</sup> A similar situation occurred in Chile, Bolivia, Peru, Democratic Republic of the Congo, Ghana and Jamaica where the mining industry was nationalized.<sup>28</sup> Some countries have subsequently privatized part of the mining industry but the sovereign risk still remains. Chile now has a mixture of state participation and private investment in the mining industry and has imposed a sliding scale of rates of royalties based on the value of sales.<sup>29</sup> Kazakhstan and Liberia have introduced a rent based tax on the exploitation of their mineral resources.<sup>30</sup>

On 13 July 2010 the Australian Newspaper published a story that the Australian government lobbied the Mongolian government, on behalf of Rio Tinto, to withdraw a special income tax at the rate of 68 percent on mining profits.<sup>31</sup> The Mongolian

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<sup>21</sup> Ibid,134.

<sup>22</sup> Ibid.

<sup>23</sup> Carole Nakhle, 'Chapter 4- Petroleum fiscal regimes: evolution and challenges,' in Philip Daniel, Michael Keen and Charles McPherson (eds) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*(Routledge, 2010) 111

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Lindsay Hogan and Brenton Goldsworthy, Chapter 5, 'International mineral taxation', in Philip Daniel, Michael Keen and Charles McPherson (eds) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*(Routledge 2010) 122, 126.

<sup>28</sup> Ibid 127.

<sup>29</sup> Ibid 125.

<sup>30</sup> Carole Nakhle, above n 23, 149.

<sup>31</sup> Rowan Callick, 'Canberra lobbied against tax', *The Australian* (Sydney), 13 July 2010, 5.

government agreed to overturn the tax in October of 2010. The Mongolian government will now take equity in the new mines in place of the increased income tax.<sup>32</sup>

Given the range of extra taxes that are imposed on mining and petroleum projects by different nations, the introduction of a MRRT in Australia should not have created the problem that it did. The fact that a PRRT has been in existence in Australia since 1988 should have provided comfort for the government that a resource rent tax would gain acceptance by the mining companies.

## II THE PHILOSOPHICAL BASIS FOR A RESOURCE RENT TAX

Mining companies pay income tax on their profits at the current rate of company tax. Imposing a resource rent tax is an additional impost on the mining company. Therefore, there must be a good reason why governments want to collect more revenue from mining companies. Many countries, including Australia, have incurred large deficits in their budgets as a result of introducing programs to stimulate their economies as a result of the 'Global Financial Crisis'. A resource rent tax is perceived as a means of reducing the deficits.

The philosophical basis for the imposition of a rent tax is justified for three reasons: first, that the minerals belong to the state and the rent tax is the price for extracting the state owned assets; second, the collection of economic rents may result in a large amount of revenue being collected without distorting production; and third, that mining companies are very large and usually with foreign ownership and that from an equity perspective a higher rate of tax could be justified.<sup>33</sup> This view is reinforced by the objective of the MRRT Bill as stated above. The objective also reinforces the fact that the mineral resources are non-renewable and the state has only one opportunity to maximise its return for the Australian community. Each of these reasons for the imposition of a resource rent tax will be examined in more detail below. However, prior to discussing the reasons for the tax this paper will outline what is meant by an 'economic rent' and how this translates into a new form of taxation.

### *A What is 'Economic Rent' or a 'Rent Tax'?*

In this paper the terms 'economic rent' and 'rent tax' are given the same meaning as they are used to describe the surplus value from the extraction of resources. One of the best explanations of the concept of 'economic rent' in the mineral resource rent tax context is the following definition provided by Professors Garnaut and Clunies Ross:

Economic rent is the excess of total revenue derived from some activity over the sum of the supply prices of all capital, labour, and other 'sacrificial' inputs necessary to undertake the activity. ... In essence, it referred to the reward that a landowner could derive by virtue simply of being a landowner and without exerting any effort or making any sacrifice.<sup>34</sup>

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<sup>32</sup> Ibid.

<sup>33</sup> Ross Garnaut and Anthony Clunies Ross, *Taxation of Mineral Rents* (Oxford University Press, 1983) 18.

<sup>34</sup> Ibid 26 and David Ricardo, *The Principles of Political Economy and Taxation*, (Everyman, 1962) chapter 2.



Garnaut and Clunies Ross acknowledge that the definition is based on the work by Ricardo.<sup>35</sup> Adam Smith also examined the concept of economic rent in his treatise on 'The Inquiry into the Wealth of Nations' and contended that rent is an unearned surplus which is appropriated by the landlords through the exercise of their monopoly power.<sup>36</sup> Smith and Ricardo considered rent to be the unearned income obtained from renting land to entrepreneurs who then grew crops or livestock. The entrepreneur took the risk in buying seeds, planting the crop, harvesting the crop and finally selling the product. The fact that the owner of the land had a monopoly and was able to extract a rent without undertaking any activity or risk, caused political economists such as Smith to develop the theoretical concept of taxing the economic rent of the landowner.<sup>37</sup> A similar situation arose with the owners of mines. The mine owners obtained a rent after capital and labour costs were deducted from the price of the minerals that had been sold. It is also acknowledged that a tax on the economic rent has a neutral effect on the landowner or mine owner.<sup>38</sup> A landowner or a mine owner would continue with their activity even though their excess profit or economic rent was subject to tax. The costs of capital and labour are already a factor in arriving at the economic rent.

A simple way of demonstrating the way in which economic rent is calculated is found in the following formulation:

$$\text{Economic rent} = \text{total revenue} - \text{total economic cost}^{39}$$

A tax is then imposed on the amount of economic rent derived from the resource at a specific rate. It is in effect a tax on the free cash flow from a resource project. It also takes into account, in determining the costs of a project, the 'opportunity costs of capital' by incorporating an uplift factor such as a long term bond rate plus a further component.<sup>40</sup> For example, with the PRRT in Australia the carry forward rate for undeducted general project costs is the long term bond rate plus 5 percent. In the case of the MRRT, the mining loss allowance is the long term bond rate plus 7 percent.

It must be noted that economic rents would not persist under standard competitive conditions.<sup>41</sup> In other words, if other mining companies entered the market because of the attraction of the size of the economic rent, then the rates of return and supply of minerals would drive the commodity price down or bid up the cost of fixed assets until economic rents were eliminated.<sup>42</sup> The economic rent is eliminated when commodity prices fall or the extraction costs are too high. In order to overcome this type of problem, many of the oil producing countries formed a cartel, namely the Organisation

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<sup>35</sup> Ibid 27.

<sup>36</sup> Adam Smith, *An Inquiry into the Nature and Cause of the Wealth of Nations* (Penguin Books 1970) 247.

<sup>37</sup> Ibid 247, and David Ricardo, *On the Principles of Political Economy and Taxation*, (Everyman, 1962)

<sup>38</sup> Joseph Keiper, Ernest Kurnow, Clifford Clark et al, *Theory and Measurement of Rent* (Chilton, 1961), 14.

<sup>39</sup> G. C. Watkins, 'Atlantic Petroleum Royalties: Fair Deal or Raw Deal?' (2001) *Atlantic Institute for Market Studies*, The AIMS Oil and Gas Papers (2), 5.

<sup>40</sup> Martin Van Brauman and Clifford Mangano, 'Resource Rent Taxation as a Basis for Petroleum Tax Policy by Foreign Governments and its Relationship to US Foreign Tax Credit Policy and Tax Law' (2000) 18(1) *Journal of Energy & Natural Resources Law* 19, 20.

<sup>41</sup> Michael Hinchy, Brian Fisher and Nancy Wallace, 'Mineral Taxation and Risk in Australia, Discussion Paper 89.8', *Australian Bureau of Agricultural and Resource Economics* (1989) 6.

<sup>42</sup> Ibid.

of the Petroleum Exporting Countries (OPEC)<sup>43</sup> as a means of controlling the price of crude oil.

### **B State Ownership of Resources**

If mineral resources are limited and owned by the state, then arguably a government should make a contribution to the value of the state for future generations such as infrastructure projects that have an enduring benefit. This way, future generations derive some benefit from the wealth generated by former generations. This will not be possible unless governments impose an additional tax on profits generated by mining companies, either by virtue of increased mineral prices or having very profitable mines. This view is also reinforced in section 1-10 of the MRRT Bill as being the justification for the introduction of the resource rent tax.

Mining companies are usually given an exclusive right to mine a particular lease. This prevents wasteful over-investment.<sup>44</sup> An example of the problems that arise with a free-for-all is found in the fishing industry where uncontrolled access leads to a dissipation of the resource or a free-for-all with gold rushes.<sup>45</sup> As Garnaut and Clunies Ross state, it is difficult to put a price on a mining lease and therefore a resource rent tax is one way in which the unknown value can be recouped by the state if the mine is economically successful.<sup>46</sup>

The Commonwealth government and governments of the States of Australia own the rights to minerals, not the registered proprietor of the land. The rights to mineral and petroleum resources in the Australian Capital Territory reside with the Commonwealth government by virtue of s 122 of the Australian Constitution. However, pursuant to the *Northern Territory (Self-Government) Act 1978* (Cth) the Territory Government has jurisdiction over all minerals except uranium resources which are under the jurisdiction of the Commonwealth Government.<sup>47</sup> The Commonwealth Government is able to claim the rights to mineral and petroleum resources located on or under Commonwealth land and offshore locations in the territorial sea and continental shelf by virtue of the *Seas and Submerged Lands Act 1973* (Cth) and the *Minerals (Submerged Lands) Act 1981* (Cth). All other mineral rights belong to the states.<sup>48</sup> The states collect royalties from mining companies based generally on the output of production at a particular price.

Dr Ken Henry and his review panel recommended the replacement of state based royalties with a uniform resource rent tax collected by the Australian government. In

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<sup>43</sup> The Organization of the Petroleum Exporting Countries (OPEC) was founded in Baghdad, Iraq, with the signing of an agreement in September 1960 by five countries namely Islamic Republic of Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. They were to become the Founder Members of the Organization. These countries were later joined by Qatar (1961), Indonesia (1962), Libya (new name yet to be determined) (1962), the United Arab Emirates (1967), Algeria (1969), Nigeria (1971), Ecuador (1973), Gabon (1975) and Angola (2007). From December 1992 until October 2007, Ecuador suspended its membership. Gabon terminated its membership in 1995. Indonesia suspended its membership effective January 2009. [www.opec.org](http://www.opec.org), 7 January 2011.

<sup>44</sup> Garnaut and Clunies Ross, above n 33,19.

<sup>45</sup> Ibid 20.

<sup>46</sup> Ibid.

<sup>47</sup> Hinchy, Fisher and Wallace, above n 41, 32

<sup>48</sup> For a detailed discussion of the rights to minerals and petroleum resources and the powers contained in the Australian Constitution see: Michael Crommelin, 'Governance of Oil and Gas Resources in the Australian Federation', (2009) *University of Melbourne Law School*, Research Series 8.



turn the Australian government would negotiate the allocation of the revenue between the state and territory governments.<sup>49</sup> The Henry Review contended that by abolishing royalties, mining companies would not have to comply with and administer two taxing systems and that a resource rent tax would promote more efficient production.<sup>50</sup> Professors Garnaut and Clunies Ross were also critical of the royalty system based on the fact that it may tend to reduce the pace and extent of extraction with the result that deposits are left in the ground where the unit costs of extraction rise.<sup>51</sup>

The State and Territory Governments charge mining companies a royalty on minerals extracted within their boundary. In the 2007-2008 year the amount of revenue collected through State royalties was AUD 4.756 billion with Western Australia raising 52 percent of the revenue; Queensland 29 percent; and New South Wales 12 percent. The other states only raised 7 percent of the revenue through royalties.<sup>52</sup> However, as a result of the 'horizontal fiscal equalization process' all states effectively share in the revenue raised through the royalties because the Goods and Services Tax (GST) revenue, which is collected by the Commonwealth government, is distributed in such a way as to compensate those states that did not raise additional revenue through resource royalties.<sup>53</sup> In effect, Queensland and Western Australia, with all of their mineral resources and royalties are not placed in any better financial position than the other states that do not have a similar level of mineral and petroleum resources. On this basis, why should the State Government of Western Australia oppose the abolition of royalties and the introduction of a MRRT? The current MRRT Bill allows for the retention of state royalties but with an allowance for royalties paid as an expense in calculating the MRRT profit.<sup>54</sup>

It is not intended in this paper to examine the competing rights to the jurisdiction over mineral and petroleum resources in Australia between the Commonwealth Government and the State Governments. That may be an issue that is left to the High Court of Australia to resolve in the future.

### ***C Efficiency and Neutrality***

An ideal taxation system does not impose impediments to the creation of value by taxpayers. Income tax may be seen as not being tax neutral if the rates of tax act as an impediment to generating more income. A rent tax is seen as being efficient and neutral because it does not tax income. In fact the Australian government proposes to reduce the rate of tax that a company pays on taxable income from 30 percent to 28 percent as a direct result of introducing the MRRT. The following discussion from the perspective of the individual provides a basic explanation of the concept of neutrality. While this discussion directly relates to the effect of income tax on the individual it can also be used to explain the concept of neutrality in the case of a resource rent tax. A resource rent tax is said to be neutral because the existence of a MRRT does not affect decisions on production, consumption, or trade.<sup>55</sup>

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<sup>49</sup> The Henry Review, above n 1, 240.

<sup>50</sup> *Ibid.*

<sup>51</sup> Garnaut and Clunies Ross, above n 33, 93.

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid.*

<sup>54</sup> Section 60-10, MRRT Bill 2011.

<sup>55</sup> Garnaut and Clunies Ross, above n 33, 21.

Ideally, any tax should be economically neutral for the taxpayer. In other words, the existence of a tax at a particular rate should have no effect on the behaviour of the taxpayer. The taxpayer should not change his or her behaviour as a result of taxation. Graeme Cooper provides the following definition of the 'optimal tax system' as defined by Mirrlees:

[A]n individual's welfare is determined exclusively by utility derived from two items – the amount that an individual consumes (C) and the amount of leisure the individual enjoys (L). The individual's welfare (U) is thus defined:

$U = u(C,L)$  ... [A] person's total utility is a function of the individual utility of each of C and L. Individuals will maximise their individual welfare by choosing the combination of leisure and consumption that yields the highest outcome.<sup>56</sup>

Put simply, an individual can achieve their optimal happiness and welfare by either working for more money or working less and having more leisure. If tax rates are too high then the individual may choose to work less and enjoy more leisure. The problem with this scenario is that the amount of tax collected is less and the tax system has caused the individual to change their behaviour as a result of the tax rates. This is also referred to as the 'substitution effect' of taxation when higher taxes lead to more leisure.<sup>57</sup> Joel Slemrod expresses his concern with any taxation that affects the behavioural response of individuals and businesses to the tax system.<sup>58</sup> He makes the following observation in support of the optimal tax system:

[T]he more the tax system induces individuals and businesses to alter their behaviour, the greater is the social cost of raising revenue. While, traditionally, economists have focused on the behavioural response of labour supply, savings and investment – sometimes called 'real' responses – in recent years the public finance community has recognised that all the behavioural responses to taxation, including avoidance and evasion, are all symptoms of inefficiency. According to this view, it is the responsiveness, or elasticity, of taxable income that determines the social cost of collecting revenue. The social cost, in turn, sets the trade-off between fairness of the tax distribution and the efficiency consequences of taxation, the trade-off that frames the ... appropriate level of tax progressivity.<sup>59</sup>

The main issue for the design of a 'good' tax system appears to be how to provide an answer to the following question; how is the burden of taxation to be spread across society? Both the comprehensive and the optimal schools of taxation provide some insight into an answer.<sup>60</sup>

The optimal tax system places emphasis on tax rates as opposed to the tax base.<sup>61</sup> The Haig-Simons comprehensive approach to taxation of income placed emphasis on what was going to be included in the definition of income tax, the tax base, whereas the

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<sup>56</sup> Graeme Cooper, 'An Optimal or Comprehensive Income Tax?' (1993-1994) 22 *Federal Law Review* 414, 434.

<sup>57</sup> Sinclair Davidson, 'Are There Any Good Arguments Against Cutting Income Taxes?' (2005) 69 *CIS Policy Monograph*, The Centre for Independent Studies, 4

<sup>58</sup> Joel Slemrod, 'The Consequences of Taxation' (2006) *Social Philosophy & Policy Foundation* 73, 73.

<sup>59</sup> *Ibid.*

<sup>60</sup> Cooper, above n 56, 422. This is the main issue facing any government designing a tax system and the main question asked by Graeme Cooper in his paper.

<sup>61</sup> *Ibid* 436.

optimal tax school, based on the writings of Ramsey in 1927 and Mirrlees in 1971,<sup>62</sup> places the emphasis on the rates of tax to be applied in order to maximise the utility of the taxpayer. The reason why this was considered to be so important was that if equity considerations were placed first then efficiency within the tax system is at risk. Efficiency within a tax system is usually 'defined in terms of deadweight loss'.<sup>63</sup> A good tax policy is one that causes less deadweight cost than another. Deadweight loss can best be described as the cost associated with raising revenue through taxation. As Sinclair Davidson observes in the following statement about deadweight losses:

[T]axes have two effects; first, they exist to raise revenue, and second, they generate deadweight losses in the form of wealth that is not created as a result of the tax on outputs. High marginal tax rates may therefore impede the revenue raising effects while also imposing high deadweight losses on the economy. This means any changes in marginal tax rates need to be evaluated in terms of the change in revenue and changes in deadweight losses.<sup>64</sup>

A further example of where tax policy has had an impact on efficiency is found in the study by the UK Open University Business School report, produced in 1998, on the behaviour of companies in Britain where it was found that 18 percent of businesses 'avoided sales to stay below the £50,000 threshold for VAT'.<sup>65</sup>

From the above analysis it can be seen that a rent tax does not have a distorting effect in the way in which income tax does on the behaviour of the individual. A rent tax applies to the free cash flow generated after all costs are deducted from the gross income and before income tax is applied to the taxable profit. A rent tax is imposed on profits after the mining company is compensated for a given rate of return on capital and labour costs being deducted from sales of the minerals, in this case the long term bond rate plus an uplift factor. The MRRT rate is incidental because the mining company has already factored in a rate of return on their costs of production. From this perspective a resource rent tax can be said to be tax neutral in terms of the above discussion on the optimal tax and comprehensive tax systems.

#### **D Resource Rent Tax and Equity**

In order to understand the concept of equity in the context of a resources rent tax it is helpful to examine the basic principle of equity in taxation. The following analysis is based on income tax but the concepts are also applicable to a rent tax on resources in Australia.

Put simply, the concept of equity in taxation is based on the perceived need to have taxpayers contributing to revenue based on their 'ability to pay', as enunciated by Adam Smith; or as expanded by J.S. Mill, the 'equal sacrifice principle'. Those with more

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<sup>62</sup> Ibid 429. Graeme Cooper provides a detailed history of the development of the optimal tax system as first enunciated by F. Ramsey in his paper on 'A Contribution to the Theory of Taxation' (1927) and the adoption of this approach by Diamond and Mirrlees in 1971 with their paper titled 'Optimal Taxation and Public Production I: Production Efficiency'.

<sup>63</sup> Terrance O'Reilly, 'Principles of Efficient Tax Law: Apocrypha' (2008) *Virginia Tax Review* 583, 585.

<sup>64</sup> Davidson, above n 57, 13.

<sup>65</sup> Binh Tran- Nam, 'Tax Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment' (1999) *Sydney Law Review* 20, 31.

income should pay more and those with less should pay less. The best advocate of vertical and horizontal equity is Richard Musgrave. Musgrave states that Adam Smith 'can be seen as an ability-to-pay theorist' and with 'a mix of benefit components'.<sup>66</sup> In other words, Smith viewed the payment of taxes as being in proportion to the benefits being obtained from the State. According to Musgrave:

J.S. Mill then separated the analysis of tax equity from the expenditure side of the budget ... Mill then translated equal ability into equal sacrifice terms. Fairness, according to Mill, required tax differentials which impose *equal absolute* sacrifice across unequal incomes.<sup>67</sup>

Richard and Peggy Musgrave have taken these concepts further by arguing that horizontal equity was linked to vertical equity. The following statement by Richard Musgrave sums up the position perfectly:

The call for equity in taxation is generally taken to include a rule of horizontal equity (HE), requiring equal treatment of equals, and one of vertical equity (VE), calling for an appropriate differentiation among unequals. HE appears non-controversial. Not only does it offer protection against arbitrary discrimination but it also reflects the basic principle of equal worth. The United States Constitution provides for 'equal protection under the law'.<sup>68</sup>

Musgrave acknowledges that 'vertical equity ... is inherently controversial. An appropriate pattern of differentiation must be chosen but people will disagree on its shape'.<sup>69</sup> He goes on to hold that 'horizontal equity appears non-controversial'. This view is endorsed by Henry Simons, of the Haig-Simons definition of income, who states that 'it is generally agreed that taxes should bear similarly upon all people in similar circumstances'.<sup>70</sup> Professor Miller raises the question as to whether it is possible to achieve equity in taxation and how it can be achieved.<sup>71</sup> He contends that horizontal equity is only achieved if all people are treated alike and if this does not occur then people will cheat on their taxes.<sup>72</sup> A rent tax is seen as potentially achieving horizontal equity by being able to impose a tax based on a cash basis and not on the taxable income generated by the mining company. Mining companies are generally multinational enterprises and they have at their disposal the means of reducing taxable income by using tax havens and engaging in transfer pricing.

From the above examination, it can be seen that taxes should be equally imposed on those of equal means, horizontal equity, and that those of little means should be taxed less than those of greater means, vertical equity. Applying this approach to a resource rent tax, there are two aspects to consider. First, in developing countries where wages are low, the citizens of that country obtain very little benefit from the mining activities of large mining companies unless a resource rent tax is imposed or a similar

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<sup>66</sup> Richard Musgrave, 'Horizontal Equity, Once More' (1990) 43 *National Tax Journal* 113, 114.

<sup>67</sup> *Ibid* 115.

<sup>68</sup> *Ibid* 113.

<sup>69</sup> *Ibid*.

<sup>70</sup> *Ibid*.

<sup>71</sup> John Miller, 'Equal taxation: A Commentary' (2000) 29 *Hofstra Law Review* 529, 531.

<sup>72</sup> *Ibid* 543.

arrangement that will generate additional revenue for the state. Second, if some countries are endowed with mineral wealth should some of that wealth be shared with less well-off countries?

Professors Garnout and Clunies Ross have pointed out that the concept of equity applies to future generations of a nation missing out on the benefits from infrastructure projects that have been developed as a direct result of additional revenue being raised through a resources rent tax. The main concern is that if the mineral wealth has been mismanaged then those future generations have nothing to show for the lost wealth that has been dissipated in the earlier years.<sup>73</sup> The amount of wealth that has accrued to a developing nation through employment opportunities is minimal and a resource rent tax is vital in order to recoup additional wealth from the limited mineral resource.<sup>74</sup>

The second aspect of equity in this context relates to the suggestion that wealthy nations with large quantities of mineral resources could consider sharing that wealth with poorer nations.<sup>75</sup> Moreover, Garnout and Clunies Ross suggest that poorer nations with mineral resources may be given priority over wealthy nations in terms of the sequence in which the former's mineral resources are exploited before the later nations' resources.<sup>76</sup> This would, in their view, promote equity among nations. However, this theory is predicated on the basis that all nations with resources impose a rent tax on the mining companies.

### ***E The Henry Report Approach to Taxing Mineral Resources***

Dr Ken Henry examines the various options for taxing mineral and petroleum resources. There are two versions of a resource rent tax (RRT) that are referred to in Chapter C of the report as well as the literature on this area of taxation. The first version is a 'Brown Tax' which is based on the work by the American economist, E Cary Brown and published in 1948.<sup>77</sup> The second version is what is known as the Garnaut and Clunies Ross rent tax. Both versions of the rent tax are similar except the 'brown tax' requires the state to recompense the mining company for expenses incurred in the exploration and early production phases where there are negative cash flows. The payment required by the state is equal to the product of the tax rate and the amount of the negative cash flow. In other words, the mining project is paid compensation by the state based on the losses incurred in the project up to that point. This would mean that governments bear some of the risk of the project and this may be substantial with very large projects that are non-productive. In some instances it may create sovereign risk for the state. The second version, the Garnaut and Clunies Ross model, is similar except negative cash flows are carried forward until such time as the project becomes cash positive. In order to compensate the project, the losses are carried forward with an uplift factor such as the long term bond rate plus a percentage. For example, under the PRRT in Australia, the uplift factor is the long term bond rate plus 15 percent for

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<sup>73</sup> Garnaut and Clunies Ross, above n 33, 21.

<sup>74</sup> *Ibid.*

<sup>75</sup> *Ibid* 24.

<sup>76</sup> *Ibid* 23.

<sup>77</sup> E C Brown, 'Business-income taxation and investment incentives', in *Income, Employment and Public Policy: Essay in honour of Alvin H. Hansen* (Norton, 1948), 300. (Also referred to in Ross Garnaut, 'The New Australian Resource Rent Tax', 20 May 2010, University of Melbourne.)

exploration expenditure or 5 percent for project development and operating expenditure. The Garnaut and Clunies Ross model has been accepted by the Australian Government and this is acknowledged in the MRRT Explanatory Memorandum.<sup>78</sup>

### **F The Australian PRRT**

In 1984 the Federal Government announced the introduction of a resource rent tax for new offshore petroleum projects and that the projects would be exempt from the imposition of royalties and the crude oil levy.<sup>79</sup> It was a further three years before the legislation was finally passed by parliament. The federal government was not able to extend the rent tax to onshore petroleum production in lieu of state royalties because the state governments of Western Australian and Queensland objected.<sup>80</sup> In 1990, Bass Strait petroleum projects became subject to the PRRT.<sup>81</sup> The North West Shelf projects are subject to a federal royalty and the crude oil levy.<sup>82</sup>

The Act was effective from 15 January 1984, even though the legislation was not passed by Parliament until 1987. The Act applied retrospectively to exploration permits awarded on or after 1 July 1984 and recognised expenditure incurred on or after 1 July 1979. It was originally imposed on offshore petroleum projects other than Bass Strait and the North West Shelf. However, oil and gas production in Bass Strait moved from a royalty and excise regime to the PRRT regime in the fiscal year 1990-1991. The PRRT was imposed on oil companies with the enactment of the *Petroleum Resource Rent Tax Act 1987* (Cth) and the *Petroleum Resource Rent Tax Assessment Act 1987* (Cth). The resource rent tax is imposed on the taxable profit of a petroleum project that is located 'offshore' in Australia. The Hawke Labor Government of 1984 introduced a resource rent tax, based on the Garnaut and Clunies Ross model, in order to remedy the state-based taxation system of imposing royalties on resource production output.<sup>83</sup> The *Petroleum Resource Rent Tax Act 1987* (Cth) is imposed on the profit at the rate of 40 percent. The *Petroleum Resource Rent Tax Assessment Act 1987* (Cth) contains the provisions relating to the calculation of the profit subject to the rent tax. The PRRT raised in excess of an additional \$1 billion a year in revenue over and above the normal company tax on income<sup>84</sup>

### **III OPPOSITION TO THE MRRT**

This part of the paper will examine the different arguments that have been proposed in opposition to the MRRT in Australia. On 2 May 2010 as part of the 'Budget' announcement the Australian government first introduced the concept of a 'resource super profits tax' on mining based in part on the recommendation of the Henry Review. This concept was met with powerful negative responses from businesses in the

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<sup>78</sup> Explanatory Memorandum, MRRT Bill (2011) 8.

<sup>79</sup> Crommelin, as above n 48, 12.

<sup>80</sup> Ibid 13.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> Rob Fraser, "The state of resource taxation in Australia: "An inexcusable folly for the nation?" (1999) *The Australian Journal of Agricultural and Resources Economics* 259, 260.

<sup>84</sup> Australian Taxation Office statistics - 2002-03 = \$1.2 billion; 2003-04 = \$1.5 billion; 2004-05 = \$2.0 billion; 2005-06 = \$1.8 billion; 2006-07 = \$1.9 billion and 2007-08 = \$ 1.6 billion.



resources sector.<sup>85</sup> Since that initial announcement of a 'super profits tax' a new Prime Minister was appointed; a Federal election has taken place in Australia; and the final MRRT Bill was introduced into Parliament on 2 November 2011. There is still some doubt that the Bill will pass the House of Representatives as one of the independent members, Tony Windsor MP is opposed to coal seam gas exploration on farming land.<sup>86</sup> The Australian Government would need his support in Parliament to pass the Bill.

### ***A Opposition by Economists***

Professor John Freebairn contends that the reforms proposed by Ken Henry would improve taxation efficiency. He finds that there are three areas that from a practical perspective need to be resolved. First, how do you treat existing mines in terms of future tax treatment and deductions for past expenditure; second, sovereign risk associated with a rent tax in place of royalties; and third, the problems that may arise between the State governments and the Commonwealth government over the ownership of resources in Australia.<sup>87</sup> Many of these initial concerns have been resolved by the fact that State royalties will still be charged by the State Governments. Similarly, the problem of ownership of mineral resources appears to have been resolved by allowing for royalties to be charged. Clearly some residual issues remain with the accounting treatment of past expenditure.

Professor Henry Ergas is opposed to a MRRT on the basis that it is an inefficient tax and may raise much less revenue than claimed by the government.<sup>88</sup> He also raises some other important issues in opposition to the proposed MRRT and these issues may need serious consideration by the government in the future. He contends that future investment in iron ore and coal projects may become less attractive because of the MRRT and investment may shift to other resources not subject to the tax.<sup>89</sup> Professor Ergas also contends that the MRRT retains the inefficiencies of the royalty system and the inefficiencies of a rent tax.<sup>90</sup> The MRRT is inefficient because it discourages investment in high risk projects while leaving unchanged the viability of low-risk projects.<sup>91</sup>

Professor Guj contends that the MRRT is not competitively neutral in that existing large mining companies will pay less MRRT compared with small to mid-tiered producers. The reason for this is that the existing mining companies are able to value pre - 2 May 2010 projects at market value for their starting base allowance which will increase their deductions from the sale price of their minerals and gas.<sup>92</sup>

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<sup>85</sup> Ross Garnaut, 'The New Australian Resource Rent Tax', 20 May 2010, The University of Melbourne, 3.

<sup>86</sup> Andrew Fraser, 'Santos boss slams Windsor's call for moratorium' *The Australian*, (Sydney), 4 November 2011, 1.

<sup>87</sup> John Freebairn, 'Taxing Mining for Use of State Owned Non-Renewable Resources' Economics Society of the ACT, Canberra, 8 September 2010.

<sup>88</sup> Henry Ergas, 'Taxation of the mining industry' Economics Society of the ACT, 8 September 2010

<sup>89</sup> *Ibid.*

<sup>90</sup> Henry Ergas, Mark Harrison and Jonathan Pincus, 'Some Economics of Mining Taxation' (2010) 29(4) *Economic Papers, The Economic Society of Australia* 369, 378.

<sup>91</sup> *Ibid.*

<sup>92</sup> Pietro Guj, 'Is MRRT competitively neutral' (2010) Association of Mining and Exploration Companies (AMEC, 2010)\ 2, [www.amec.com.au](http://www.amec.com.au) 14 November 2011.

Clearly there will be teething problems with the introduction of the MRRT. However, the taxing provisions are similar to the existing PRRT and that system appeared to be acceptable for oil companies for over 14 years.

### ***B Political Opposition***

The Leader of the Opposition party in the Australian Parliament, Tony Abbott MP claims that imposing a MRRT on mining companies was 'an economic version of the tall poppy syndrome'.<sup>93</sup> He maintains that it is sufficient for mining companies to pay income tax and that their employees pay personal income tax and as miners, they pay state royalties.<sup>94</sup> He was therefore of the view that no more taxes should be imposed on mining unless there is some unique feature.<sup>95</sup> This attitude to a proposed MRRT is quite remarkable given that many foreign countries impose additional taxes on mining companies on the basis that the mineral resources are finite and that the additional revenue may provide benefits for future generations. It is even more remarkable given that the Howard Government was in power in Australia for 14 years and at no time considered revoking the PRRT which was adding at least one billion dollars to government revenue.

### ***C Mining Company Opposition***

Mining companies naturally opposed the MRRT because they will now be required to contribute a greater share of their taxable profit to the Australian government if they are involved in the sale of iron ore, coal or petroleum products. The MRRT is imposed on a miner's mining profit, less its MRRT allowances, at a rate of 22.5 per cent. That is at a nominal rate of 30 per cent, less a one-quarter extraction allowance to recognise the miner's employment of specialist skills. The mining company will pay company tax on the taxable income at the rate of 28 percent, giving an overall effective tax rate of 50.5 percent. The three largest mining companies, namely BHP, Rio Tinto and Xstrata have accepted the current MRRT and are prepared to pay the tax. The executive chairman of Fortescue Metals Group, Mr Andrew Forrest still opposes the tax but contends that his company will avoid paying the MRRT for at least five years due to the starting base allowances reducing their profits.<sup>96</sup> He also contends that the big mining companies such as BHP, Rio Tinto and Xstrata are in a similar position and will not pay the MRRT for many years.<sup>97</sup> Mr Forrest contends that the Government has overestimated the amount of revenue that will be collected and therefore should scrap the tax.<sup>98</sup>

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<sup>93</sup> Matthew Franklin and David Uren, 'Abbott mines resources sector' *The Australian* 24 December 2010, 8.

<sup>94</sup> *Ibid.*

<sup>95</sup> *Ibid.*

<sup>96</sup> Andrew Burrell and Siobhain Ryan, 'Levy writeoffs "shield" Fortescue' *The Australian* (Sydney), 8 November 2011, 6.

<sup>97</sup> *Ibid.*

<sup>98</sup> *Ibid.*



#### IV CONCLUSION

Australia has had a resource rent tax on petroleum projects under the existing PRRT regime. It would appear that the Australian government should succeed in having a MRRT imposed on iron ore and coal projects from 1 July 2012 provided the Bill passes the House of Representatives with the assistance of the independent members of Parliament. The design and implementation of the MRRT is on similar lines to the PRRT which has raised additional revenue over the past 14 years. However, according to some economists there are issues that still need to be resolved in the practical application of the MRRT to various mining companies, especially small to medium explorers. The mining industry naturally opposed the introduction of a MRRT as it would result in a greater share of its taxable profit being paid to the Australian government. In fact with a 22.5 percent MRRT and a company tax rate of 28 percent, the total tax take represents about 50.5 percent, clearly well below that amount being claimed by other countries, in particular the UK from petroleum projects based in the North Sea.

Future generations of Australian taxpayers will eventually judge the manner in which the non-renewable mineral resources have been exploited and the return that was extracted for the benefit of all Australians. Given that most resource rich countries have been extracting additional revenue from mining companies, the proposed MRRT in Australia is clearly defensible. This then answers the question raised in this paper: namely, why the concern about a proposed MRRT? The answer must be that there is no need for concern as the PRRT has been raising additional revenue for over 14 years and other countries have been imposing a similar tax for many years without an apparent adverse impact on the mining industry.

**TAXING THE TAXED - DUPLICATION OF TAXATION IN PROPERTY  
INSURANCE AND ITS SOCIETAL IMPLICATIONS**

RACHEL ANNE CARTER\*

**ABSTRACT**

This paper examines the recommendation by the Henry Report that the methodology for taxing insurance policies be modified. The imposition of a Fire Services Levy, stamp duty and Goods and Services Tax (GST) duplicates the amount of tax paid on insurance policies. The paper will explore the fiscal strength of these taxation implications in ensuring stability and predictability. The paper will thus focus upon the way that taxation implicates social preparedness for risk minimisation and a reduction in reliance upon the government particularly after catastrophic events. Ultimately the paper seeks to align the taxation pedagogy with the societal implications tax has on the insurance market. The paper will do this through the lens of enabling greater access to insurance and promoting community resilience.

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## I INTRODUCTION

*A society that learns from catastrophes, that changes its laws, strengthens its infrastructure and repairs mistakes is a society that deserves the respect of its people. To ignore the lessons of history is to condemn us all to repeat its mistakes.<sup>1</sup>*

In adhering to the profound words of Justice Kirby we must change the way insurance transactions are taxed. Australia's Future Taxation Report ('Henry Review') of May 2010 sparked a ring of outcry about the current taxation system and in particular the way general insurance is taxed.<sup>2</sup> Subsequently the Final Report of the Royal Commission on the Victorian Bushfires<sup>3</sup> brought further scathing criticisms about the way insurance is taxed. The basis for criticism is that high numbers of uninsured and inadequately insured individuals, particularly in Victoria (and New South Wales) but also to a lesser extent the other states, are being forced out of the insurance market due to cost rather than choice.<sup>4</sup> The system is criticised as being inefficient, ineffective and inequitable in the way that it taxes insurance products. Although vehement opposition to state taxes on insurance has been more visible in 2010, this is a debate which has gained momentum over a number of years.<sup>5</sup> In 2003 the taxation problems were attributed to the collapse of the former insurance giant, HIH Insurance.<sup>6</sup> Even the States themselves have recognised that taxing insurance transactions is undesirable.<sup>7</sup> This begs the question: given there are so many proponents for the abolition of the current taxation regime why is the system of taxing insurance stagnant? Why does its inefficiency continue to fester resulting in insurance exclusivity, increasingly exposing the government to liability after major events? The duplication or 'cascading effect'<sup>8</sup> of the current taxation regime as applied to insurance is the result of the Fire Services Levy (in Victoria and New South Wales) and the GST in all states. These are cumulatively added to the policy cost and this is then subject to stamp duty. Ultimately this places a disproportionately high burden upon those prudent enough to insure. Those who are

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<sup>1</sup> Michael Kirby, 'After the Fires Die Down and the Lawyers Depart' (Paper presented at Australasian Fire & Emergency Services Authority council Annual Conference, Darwin, 9 September 2010) 4.

<sup>2</sup> Ken Henry, *Australian Future Tax System: Final Report* (Australian Government Publishing Service, 2010).

<sup>3</sup> Victoria, Royal Commission into the 2009 Victorian Bushfires, *Final Report* (2010) Summary, 36, Recommendation 64.

<sup>4</sup> Similarly the National Insurance Brokers Association also claims that the Fire Services Levy, stamp duty and other taxes constitute a direct means of discouraging the uptake of insurance in the community. See National Insurance Brokers Association, 'National Insurance Brokers Association Insurance Taxes Discussion Paper: What you need to know about taxes on insurance' (Report, National Brokers Association, May 2009).

<sup>5</sup> State Business Tax Review Committee, *Victoria: Review of State Business Taxes*, Summary Report, February 2001, Recommendation 1(1), Recommendation 5; Commonwealth, Royal Commission on the Failure of HIH Insurance, *Final Report* (2003) Vol 1, Recommendation 55 – 8; Michael Keating et al, *IPART (Independent Pricing and Regulatory Tribunal of New South Wales) Review of State Taxation- Report to the Treasurer* (2008) Recommendation 8 – 10.

<sup>6</sup> Commonwealth, Royal Commission on the Failure of HIH Insurance, *Final Report* (2003) pt 3, Recommendation 56 [10.3.3]

<sup>7</sup> Neil Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry' (Paper presented at Conference on Australia's Future Tax System: A Post- Henry Review, Sydney, 21 – 23 June 2010) 43.

<sup>8</sup> Justice Owen, Commonwealth, Royal Commission on the Failure of HIH Insurance, *Final Report* (2003), pt 3 [10.3.3]

insured are paying for the fire prevention services in Victoria and New South Wales. In all states, those who are insured contribute to a substantial proportion of the overall tax revenue, effectively enabling others to free ride and still have access to the same services.<sup>9</sup> The taxation burdens can double the base premium. The problem is further complicated by the lack of transparency preventing many from understanding or even knowing that the cost of insurance is substantially increased by these taxes. The implication of having a defunct taxation system with its surrounding uncertainty is detrimental domestically. Furthermore it is also 'damaging our international competitiveness'.<sup>10</sup> Therefore we should take heed of the advice of the Honourable Justice Kirby and 'repair mistakes'<sup>11</sup> implementing a much fairer system. As Justice Kirby highlights, the failure to 'ignore the lessons of history is to condemn us all to repeat mistakes.'<sup>12</sup>

The absurdity of the taxation regime is exemplified by the fact that insurance products are often taxed at the same level as luxury items such as alcohol, gaming and tobacco products.<sup>13</sup> This sends out a confusing message to consumers suggesting that insurance is a luxury product rather than one of necessity. The bulk of transactions which are taxed at a high rate are aimed at 'discouraging activities deemed to have negative side effects.'<sup>14</sup> However, insurance is in every way beneficial for society and taxing insurance products in such a way leads to market distortion.<sup>15</sup> This paper does not advocate insurance as being compulsory, rather that the insurance market with its tax ramifications be modified to facilitate choice by aborting current practices which result in insurance being an elusive product. Greater access will only arise when insurance is affordable, thus a disbandment of the current practices making the cost of insurance simply unattainable must be undertaken.<sup>16</sup> The way insurance is taxed requires a choice as to 'how much inequity is allowed according to institutions, norms, laws, policies and programs.'<sup>17</sup> A high level of insurance amongst society not only benefits individuals by providing them with financial security, but also has sociological benefits. The primary sociological benefit of high levels of insurance is that it reduces the level of

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<sup>9</sup> Keating et al, above n 5, 1.

<sup>10</sup> Ken Henry, 'Confidence in the operation of the tax system' (Paper presented at Taxation Institute of Australia Conference, Sydney, 13 March 2009) 42.

<sup>11</sup> Kirby, above n 1, 4.

<sup>12</sup> Ibid.

<sup>13</sup> This can clearly be illustrated by the fact that during the period 1998 – 1999 to the period 2007 – 2008 the average amount of tax received in Victoria from gaming machines was \$878m whereas the average taxes on insurance during the same period was \$858m per year. See Insurance Council of Australia, Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee, *Inquiry into State Government Taxation and Debt*, October 2009, 3; National Insurance Brokers Association, above n 4.

<sup>14</sup> Zsolt Darvas and Jakob Von Weizsacker, 'Bruegel Policy Contribution: Financial Transaction Tax: Small is Beautiful' February 2010, 7 <<http://www.bruegel.org/publications/publication-detail/publication/373-financial-transaction-tax-small-is-beautiful>>

<sup>15</sup> Darvas and Von Weizsacker, above n 14; Richard Tooth and George Barker, 'The Non- Insured: Who, Why and Trends' (Discussion Paper, Insurance Council of Australia, 2007) 29.

<sup>16</sup> Dr Henry focuses upon the need for the taxation system to facilitate individuals with choice whereby through such choice they can effectively support themselves rather than the current system which seems to be 'locking people into the welfare system, potentially entrenching chronic deprivation' and encouraging reliance upon welfare. See Ken Henry, 'How much inequity should we allow?' (Paper presented at Australian Council of Social Service National Conference, 3 April 2009) 28 – 9.

<sup>17</sup> Ibid 22.

governmental dependence. We cannot continue taxing the taxed, forcing the most vulnerable members of society out of the insurance market due to the enormous financial burden of insurance which is largely attributable to tax.<sup>18</sup> The outcome of prohibitive costs creating high levels of under insurance and uninsured individuals is that after an event causing widespread loss there will be large government expenditure on the recovery phase as most of these people will not be able to fund their own recovery in the absence of insurance. This in turn will increase the cost of insurance, perpetrating the vicious cycle of more uninsured individuals who will rely upon the government after a loss bearing event. This will inflate government spending on disaster recovery and thus reduce available revenue in other areas. It would be much better to reduce the costs of insurance by lowering the tax burden and thus promoting greater resilience.<sup>19</sup>

In Victoria the problems with taxing insurance can be exemplified by the fact that 59.6% of the total number of uninsured and inadequately insured people would have reasonable levels of insurance cover if these consumers were not subject to either the Fire Services Levy or stamp duty on their policies.<sup>20</sup> In Australia the last few years have seen a marked increase in the number of weather related disasters which are becoming increasingly frequent and increasingly severe.<sup>21</sup> Given the reality of Australia being subjected to an increasing number of natural disasters, rather than retaining a tax system which discourages people from obtaining insurance and having massive government expenditure in the aftermath, it would be much better to create resilient communities.<sup>22</sup> Enabling access to insurance would also promote greater equity to ensure the taxation burden is not disproportionately high for those who are prudent enough to insure. Individuals should contribute in fair and reasonable ways to attain a tax equilibrium which promotes stability and predictability. Ultimately the emphasis should be upon 'developing a long term blueprint for a tax-transfer system that is focused on sustainable prosperity for Australia.'<sup>23</sup> Part of the solution to creating a superior taxation system involves the abolition of inefficient state taxes from insurance products.

One of the major implications which cement the current system is the federal/state divide. At the heart of any state reluctance to change the taxation regime is the uncertainty about retaining sufficient taxation revenue to serve the needs of the state. Therefore, from a pragmatic perspective in light of political constraints, in order for the system to be altered it is necessary that a viable option is suggested to replace the tax lost from transactional insurance tax. The states are unlikely to agree unless an alternative can be found to enable the States to continue to offer high levels of services

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<sup>18</sup> RACV, Submission to Treasury, *Inquiry into the State Government Taxation and Debt*, October 2009, 1, 3 – 4; National Insurance Brokers Association, above n 4.

<sup>19</sup> Edward Mortimer, Anthony Bergin and Rachel Carter, 'Sharing the Risk: Distributing the Cost of Natural Disasters in Australia' (2011) 1; Council of Australian Governments, *Natural Disasters in Australia-Disaster Insurance*, August 2002, 75 – 80.

<sup>20</sup> Richard Tooth, 'An Analysis of the Demand for House and Contents Insurance in Australia: Insurance Council of Australia- Industry Focus' (Report, Insurance Council of Australia, 2007) 2 – 3.

<sup>21</sup> Karl Sullivan, 'Policy Implications of Future Increases in Extreme Weather Events due to Climate Change' (2008) 23 *The Australian Journal of Emergency Management* 37, 42.

<sup>22</sup> Mortimer, Bergin and Carter, above n 19.

<sup>23</sup> Henry, 'Confidence in the Operation of the Tax System', above n 10, 42.

whilst maintaining both current and future economic stability.<sup>24</sup> Therefore part of the solution will require agreement between the Commonwealth and the State governments about a workable funding system<sup>25</sup> particularly through an increase in collaborative taxation regimes.

## II MORE THAN JUST FIGURES...WHERE THE MONEY REALLY COUNTS

The amount of revenue a state receives from taxing the insurance industry forms a large part of the budget of each state. In 2005 – 2006 the cumulative amount of taxes received directly from insurance was \$3.7 billion.<sup>26</sup> During this period, Victoria retained the largest proportion of state funding from taxes on insurance, with it amounting to 10.1%<sup>27</sup> of the overall taxes for the state for that year.<sup>28</sup> In the Northern Territory there was the smallest proportion of funding through taxes on insurance whereby such taxes only amounted to 2.9% of overall funding during the 2005- 2006 period.<sup>29</sup> In Victoria alone in the period 1998 – 2008, the average collection of tax from insurance contracts was \$858 million per year.<sup>30</sup> In Victoria by the 2009 – 2010 financial year the overall amount which the state received in taxes imposed upon insurance was in excess of \$1.4 billion.<sup>31</sup> This contributed to the overall tax increase resulting from the Black Saturday fires in February 2009 which saw the need for greater funding for fire brigades.<sup>32</sup> Whilst there was obvious benefit to the fire brigade possessing additional funding allowing it to expend more on operational costs, the burden of this money fell heavily upon insurance consumers. This is particularly problematic as ‘most consumers are cost conscious to some degree and the natural tension between cost and level of protection

<sup>24</sup> Insurance Council of Australia, *Inquiry into State Government Taxation and Debt*, above n 13, 1.

<sup>25</sup> Neil Warren, ‘Policy Forum: The Henry Review of Taxation – The Henry Review, State Taxation and the Federation’ (2010) 43(4) *The Australian Economic Review* 409, 412 – 416; Attorney General’s Department, Parliament of Australia, *Australia’s Future Tax System: Report to Treasurer* (2009) G2- State Reform, Rec 119, 103.

<sup>26</sup> Insurance Council of Australia, ‘Current Issues in Brief: Tax on Insurance’ (Report, Insurance Council of Australia, September 2006) 1.

<sup>27</sup> *Ibid.*

<sup>28</sup> The amounts which of the total budget for each of the states and territories for which insurance taxes formed an essential component can be seen below.

INSURANCE TAXES AS A SHARE OF TOTAL STATE TAXES (2006 / 2007)	
Victoria	10.1%
South Australia	9.7%
Tasmania	7.6%
New South Wales	6.9%
Western Australia	6.7%
Queensland	4.4%
Australian Capital Territory	4.4%
Northern Territory	2.9%

Source: Insurance Council of Australia, ‘Current Issues in Brief: Tax on Insurance’, above n 26, 1.

<sup>29</sup> *Ibid.*

<sup>30</sup> Insurance Council of Australia, *Inquiry into State Government Taxation and Debt*, above n 13, 1.

<sup>31</sup> John Lenders and Tim Holding, ‘Financial Report for the State of Victoria 2009 – 2010’ (Paper No 374, Parliament of Victoria, 2010) 14.

<sup>32</sup> *Ibid* 130.



purchased drives a tendency for consumers to under insure.<sup>33</sup> In Western Australia during the 2009- 2010 financial year the amount received in state taxes levied through insurance premiums was \$428 million which is an increase of \$22 million from the projected amount.<sup>34</sup> Although many states have been vocal in their dissatisfaction with the taxation system and its treatment of insurance policies, the amount of revenue received makes the reality of taxation a numbers game.

Many states forget that tax should be more than just a game involving numbers. Taxation has great sociological implications. Inefficient taxes have the potential to create negative long term economic consequences for individuals and communities. The taxation system, in collecting huge sums of money, directly impacts upon the lives of the most taxed people in our society; those from a low socioeconomic background. The way insurance is taxed is inequitable in that it serves neither horizontal nor vertical equity principles. In a report detailing insurance taxes the marginal excess burden of the insurance taxes was exceptionally high, being 67 cents out of each dollar collected.<sup>35</sup> Pragmatically, states do need money to provide facilities and services necessary for any society. However, having a tax system where 67% is already directly allocated to existing revenue concerns without allowing tax revenue for the improvement of services and facilities is simply not beneficial. The question is therefore how to create the most efficient tax equilibrium that has the least implications for society as a whole. The creation of such tax equilibrium would require a reduction in the administrative and other dead weight costs which society currently endures. Essentially reform is needed to move from a narrow tax base towards achieving a tax system founded on broader thematic objectives which benefit more members of society. Instead of having transactional taxes these should be replaced with a 'linear tax'.<sup>36</sup> Having a taxation regime based upon linear tax methodology is likely to improve access to insurance and enhance the quality of the insurance product the consumer is receiving.<sup>37</sup> This restructure must have due regard for societal concerns and be based on a framework of stability, predictability and equity. Moving away from a narrow tax trajectory (of purely transactional taxes) to a more socialist based tax regime will increase the fiscal strength of the tax system and serve the objectives of stability, predictability and equity.

### **III FEDERAL/STATE DIVIDE- STATE RELUCTANCE TO DISBAND TAXATION ON INSURANCE THE BULWARK AGAINST CHANGE**

Many criticisms about inefficient state taxes fail to mention constitutional limitations. Part of any process to reform the state tax system will require recognition of the 'impediments to implementing state tax reform arising from intergovernmental fiscal

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<sup>33</sup> Institute of Insurance Actuaries, 'Submission to the Garnaut Climate Change Review – Update 2011' (3 March 2011) 1, 7 at [www.actuaries.asn.au](http://www.actuaries.asn.au).

<sup>34</sup> The Government of Western Australia, *Annual Report on State Finances 2009 – 2010*, September 2010, 140 (Table 2.1 'General Government Operating Revenue').

<sup>35</sup> KPMG, *Econtech CGE Analysis of the Current Australian Tax System- Final Report*, 26 March 2010, 44 (Table 5.1).

<sup>36</sup> Mikhail Golosov and Aleh Tsyvinski, 'Optimal Taxation with Endogenous Insurance Markets' (2007) *May Quarterly Journal of Economics* 487, 522 – 3.

<sup>37</sup> *Ibid.*

arrangements'.<sup>38</sup> These impediments are an important consideration as these will determine whether the states will be realistically willing to disband transactional taxes such as those on insurance. Consideration of such impediments also postulates what needs to be implemented to facilitate the removal of inefficient state transactional taxes. Although theoretically possible to encourage the states to surrender their taxation of insurance, the stronghold on the ability to raise such substantial revenue is likely to be held with an iron grasp. From an economic standpoint, the collaboration of the states in a more centralised system of taxation would be 'more feasible as better flows of information between taxpayers and administrators'<sup>39</sup> would be provided. The way the current taxation system is predicated provides no real incentive for individual states to undertake radical reforms or to abolish transactional taxes.<sup>40</sup> In fact it has been suggested that the states who do this are faced with three potential problems:

- Firstly, economic uncertainty whereby a state may have to be much more competitive to gain even the same level of funding.<sup>41</sup>
- Secondly, there are political problems for the state who implements such changes due to a society being content to retain the status quo.
- Lastly there are also risks in the way a new system would be run, enforced and administered and the costs associated with these implementation regimes.<sup>42</sup>

The constitutional implications entrenching the intergovernmental grant system act as a disincentive for states to abolish insurance based taxes. States are reluctant to disband such taxes and they often acknowledge the fiscal weakness of a taxation regime heavily reliant upon transactional taxes.<sup>43</sup> However, any suggested rectifications of the state taxation regimes have political considerations, particularly due to the potential for Commonwealth fiscal dominance which may lead to the Commonwealth exerting economic control so that it can shape the affairs of each state. In particular, the states are concerned about the current system of fiscal federalism in Australia due to which, essentially rather than risking economic uncertainty, the states retain transactional taxes as a source of state revenue.

If the states surrender their power to tax insurance transactions and thus accept a significantly reduced state budget, there will need to be an increase in Commonwealth grants. However at the moment there is great variance in the way that grants are provided which impinges upon the way that insurance is taxed in each of the states. The main problem with the Commonwealth's ability to give financial grants to the states is that under s 96<sup>44</sup> the Commonwealth effectively controls the allocation and spending of money. 'The real politick of fiscal federalism in Australia is that the Commonwealth collects the lion's share of revenue and then exerts fiscal leverage over the states.'<sup>45</sup>

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<sup>38</sup> Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry' above n 7, 4.

<sup>39</sup> Ken Henry, 'The Future of State Revenue' (Paper presented at Commissioners' Conference, Sydney, 27 March 2009) 36.

<sup>40</sup> Warren, 'The Henry Review, State Taxation and the Federation', above n 25, 419 – 20.

<sup>41</sup> Ibid.

<sup>42</sup> Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', above n 7, 52.

<sup>43</sup> Ibid, 43.

<sup>44</sup> *Australian Constitution*.

<sup>45</sup> Patrick Keyzer, *Principles of Australian Constitutional Law* (LexisNexis Butterworths, 3<sup>rd</sup> ed, 2010) 258.

The outcome of this is that it may allow the Commonwealth to dictate to states by imposing terms and conditions which must be agreed to prior to funding being allocated.<sup>46</sup> The alternative for a state asserting their autonomy and failing to accept any terms or conditions imposed on Commonwealth grants could result in the denial of sufficient revenue which a state needs to provide basic services and facilities. Therefore the problem with state taxes is not merely a problem with the legal regulatory regime for transactional taxes but a more deep seated issue surrounding federalism.

If the Australian Government is serious about state tax reform, it must acknowledge that it will not and cannot be undertaken by the states alone. This is not because they oppose reform...rather it is because the benefits from the state "going it alone" only marginally accrue to the state itself...there is not the funding available in the short to medium term to ensure "every state is a winner".<sup>47</sup>

Therefore any resolution needed to fix problems with transactional taxes on insurance must encompass political and economic aspects. Reality dictates that taxation outcomes are coloured by the political and economic factors, most of which are often ignored.

It is not only the practicalities of the system which need to be reconsidered but also the entire methodology upon which the system is based. It has been suggested a more favourable methodology to produce efficient taxation outcomes which in turn better facilitate the participation of each of the states is to adopt a 'bottom up'<sup>48</sup> approach. This 'bottom up' approach would determine the amount of taxes each state realistically needs for proper operations, services and facilities. The amount of money needed for the basic operations must then be the very minimum amount provided. The states should be given additional funds based upon practical considerations about the increasing cost of providing services and facilities for that state. There must also be a reduction in the conditions imposed upon Commonwealth funding that is provided to the states. If states are satisfied at the outset they would be given an unconditional minimum amount of money which would be sufficient for the operation of that state, this is likely to enable them to better make a decision about their financial ability to abolish taxes on insurance. Currently, given the 'state revenue offices are responsible for the collection of over \$45billion in taxes each year',<sup>49</sup> they are a crucial part of the Australian tax system. State taxes are a serious matter. Thus the requirement of the states that they retain their autonomy if they abolish transactional taxes should be seen as a legitimate concern to address in the reform process. The maintenance of state autonomy in an increasingly centralised system may require a greater bargaining process as a requisite methodology to be employed in the creation of a more equitable, stable and predictable system.

States should be given recognition for innovation and efficiency within the way the taxation revenue is allocated. Efficient states should be rewarded.<sup>50</sup> Rewarding

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<sup>46</sup> *Victoria v Commonwealth* (1926) 38 CLR 399, 417; *South Australia v Commonwealth* (1942) 65 CLR 373.

<sup>47</sup> Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', above n 7, 52.

<sup>48</sup> *Ibid* 46.

<sup>49</sup> Henry, 'The Future of State Revenue', above n 39, 32.

<sup>50</sup> The term efficiency is a difficult concept to define but ultimately what it refers to is the question proposed by the optimal tax theory which essentially requires a balancing between disincentivising work

efficiency and accountability will promote an enhanced system, whilst providing sufficient incentive to continue to operate in an effective manner. Rewarding the efficiency of each of the states should be a key to unlocking the current distortion and providing clarity, certainty and minimising the effect of taxation as a numbers game.<sup>51</sup> Currently if we maintain the status quo and do not reward efficiency, then there is really no incentive for the states to be maintaining and adopting efficient systems. Thus the states have been shown to follow the predictions of behavioural economists: rather than incurring significant expenditure in implementing new and innovative mechanisms to ensure efficiency, states will be more likely to retain the existing regimes as there is no tangible benefit arising from innovation and efficiency in the way that tax is imposed and collected.

With knowledge of the political and economic scope of which our state regulatory tax regimes operate, the paper will now look at the components of the insurance policy costing, in particular paying heed to the taxes applied.

#### **IV FIRE SERVICES LEVY- LACK OF TRANSPARENCY AND ACCOUNTABILITY**

##### ***A Victoria and New South Wales- Practical Operations of the Fire Services Levy***

In Victoria<sup>52</sup> and NSW the problems with the way insurance policies are taxed begin with the Fire Services Levy. In Victoria 75% of the funding for the Metropolitan Fire Brigade<sup>53</sup> and 77.5% of the funding for the Country Fire Authority<sup>54</sup> comes from the taxes payable on insurance premiums. In NSW 73.7% of the funding for state emergency services must be provided through taxes gained from insurance premiums.<sup>55</sup>

The amount that is chargeable as a Fire Services Levy when added to the initial policy cost will increase the cost of the premium substantially. When the Fire Services Levy is added to the other taxes, being the GST and stamp duty, the cumulative effect of these

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or other useful activities due to the tax implications and rather to 'maximise the sum of the utilities of individuals with identical preferences'. See: Reuven S Avi-Yonah, 'Why Tax the Rich? Efficiency, Equity and Progressive Taxation' (2002) 111(2) *The Yale Law Journal* 1391, 1400.

The Inspector General of Taxation has referred to efficient taxes as those which 'do not skew resource allocation decisions across the economy, contributing to a strong, productive economy.' See Australian Government (Inspector General of Taxation) 'Policy Framework for Review Selection' (Issue Paper No 2, Inspector General of Taxation, 2003) [http://www.igt.gov.au/content/Issues\\_Papers/Issues\\_Paper\\_2.asp](http://www.igt.gov.au/content/Issues_Papers/Issues_Paper_2.asp). Essentially the way this paper sees efficiency encompasses ideas from the abovementioned sources but also must be seen within a framework of transparency, accountability and more importantly contextualised in light of the impact it has both upon society and the provision of services particularly the ability to obtain insurance and the implications for inadequate insurance as well as the implications which this has for the individual.

<sup>51</sup> Neil Warren, *Fiscal Equalisation in Australia: High Level VFI and Equity Focused HFE- CESifo DICE Report* (January 2008) 11 – 3 <http://www.cesifo-group.de>.

<sup>52</sup> The problem with the Fire Services Levy was acknowledged as being problematic with the tax burden on insurance being too high. See: Victoria, *Parliamentary Debates*, Legislative Assembly, 10 November 2009, 3762 (Tim Holding, Minister for Minister for Finance, Work Cover and the Transport Accident Commission).

<sup>53</sup> *Metropolitan Fire Brigades Act 1958* (Vic) s 37(1)(c).

<sup>54</sup> *Country Fire Authority Act 1958* (Vic) s 76(1)(b).

<sup>55</sup> *State Emergency Services Act 1989* (NSW) s 24F(2)(c).

taxes is that they can increase the base premium anywhere between 50%<sup>56</sup> to 'a staggering 123%.<sup>57</sup> This increase reduces and distorts the pool of insured individuals to a small segment of the community and effectively excludes membership. Many individuals and groups who recognise the importance of insurance are forced out of the market not by choice but rather due to the unrealistic financial burden imposed.<sup>58</sup>

### ***B The Blindness Surrounding the Imposition of the Fire Services Levy***

Cost is not the only problem with this form of taxation. There are also problems associated with a system that is opaque when it should be transparent. Many do not know about the way taxes on insurance are calculated. Furthermore few know that such taxes are directly attributable to the high costs of insurance.<sup>59</sup> This tax leads to inefficiency where the 'impost on the insured is too high and has become a disincentive for property owners to adequately insure.'<sup>60</sup> Taxation works effectively if there is vertical and horizontal equity, yet the current system is not only inefficient but also

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<sup>56</sup> *State Emergency Services Act 1989* (NSW). Furthermore under Schedule 2, Column 1(1) the total amount payable on premiums as an emergency services levy for property is 80% of the premium and for households is 50% of the premium thus adding a considerable expense to the insurance premium. See *State Emergency Services Act 1989* (NSW) sch 2.

<sup>57</sup> This amount is calculated based upon the percentage increase after the Fire Services Levy, GST and stamp duty is attached to an insurance policy for Victorian country commercial insurance.

Noel Pettersen, 'Fire Services Levy and Insurance Discussion Paper' (Discussion Paper, National Insurance Brokers Association, 2009) 1 <<http://www.niba.com.au/html/37589.cfm>>; Professor Danuta Mendelson and Rachel Anne Carter, *Catastrophic Damages- Liability and Insurance: Australia* (Forthcoming, 2011).

Taxes imposed upon policies to protect private urban dwellings are not as high as country commercial dwellings, yet still add 15-50% to the price of insurance before other taxes is imposed. See Tooth and Barker, above n 15, 4.

<sup>58</sup> In 2001 a survey was conducted by the Public Accounts Committee suggesting that as many as 39% of the respondents were either uninsured or inadequately insured, much of which was directly due to the increased cost which transactional taxation on insurance imposes.

See Public Accounts Committee, Parliament of New South Wales, *Review of Fire Services Funding* (2004), 54; Insurance Australia Group Ltd, Submission 11 to Treasury, *A National Survey of Small and Medium Business*, July 2001.

This is not a problem which has improved with greatly with the passage of time, rather in Victoria after the Black Saturday fires in 2009 the amount of uninsured or inadequately households was 20%.

See Joshua Whittaker et al, *Victorian 2009 Bushfire Research Response Household Mail Survey* (January 2010) Bushfire CRC < <http://www.bushfirecrc.com/publications/downloads/Mail-Survey-report-10-1-10-rt-2.pdf>>

<sup>59</sup> Although the insurance companies collect a Fire Services Levy which is a tax on insurance premiums, insurers do not know prior to issuing insurance policies of their exact obligations for a particular year as this is determined by their market share. Therefore insurance companies may either over- or under-collect the Fire Services Levy. If the insurer's estimate is too high a consumer will not be entitled to a reimbursement for the excess tax they were charged. As there is very little transparency and accountability on the part of the insurer to account for each tax dollar raised as a Fire Service Levy, part of the taxation revenue may be a deadweight loss for the government, instead creating a windfall gain towards an insurer's profitability. See Public Accounts Committee, Parliament of New South Wales, *Review of Fire Services Funding* (2004); Victoria, *Green Paper- Fire Services and the Non Insured*, Parliamentary Paper (2009); Property Council of Australia (Victorian Division), *Fire Services Funding Review (A Submission Prepared by the Property Council of Australia)* (2003); Tooth and Barker, above n 15, 37.

<sup>60</sup> Victoria, *Green Paper- Fire Services and the Non Insured*, above n 59, 2.



inequitable.<sup>61</sup> Fluctuations within the insurance market affect the amount of tax collected. This is not economically sound as it fails to provide predictability particularly as insurance prices continue to sky-rocket. The taxation system must be stable and predictable and not be affected by transactional or other market constraints.

Part of the weakness of the current taxation regime on insurance is that 'the Fire Services Levy is almost a hidden tax and is generally poorly understood by the public. The complexity of the arrangements works against the public understanding.'<sup>62</sup> Unfortunately the evidence has shown thus in some instances that the lack of transparency has clouded the situation and enabled a greater amount to be expropriated in the form of taxation than actually fully accounted for and expected in terms of the taxation obligation. 'The 2003 Department of Treasury and Finance Review of the Victorian Fire Service Funding Arrangements found that assuming the contributing insurance companies had charged the Insurance Council of Australia recommended rates, in the four years prior to 2003 fire services levy collections had exceeded the amount required to meet statutory contributions by a total of \$46.85m for the Metropolitan Fire Brigade and \$3.68m for the Country Fire Authority.'<sup>63</sup> Similarly in New South Wales since 2004 there have been calls to overhaul the existing system for taxing insurance policies. The system is 'inefficient as it distorts economic efficiency by being a significant additional cost (a deterrent) on the purchase of appropriate insurance.'<sup>64</sup>

### ***C Accountability for the Collection of the Fire Services Levy***

There is no specific rule dictating what an insurance company must do with any additional funds collected. Historically, money which has been collected under the guise of a Fire Services Levy has been retained if the amount collected exceeded the statutorily required amount. Insurance companies do not even have to inform consumers about any excess tax collected.<sup>65</sup> One of the big problems with taxation on insurance is that the insurance consumers usually do not even know they are being subjected to such high levels of taxation. The lack of knowledge is prevalent despite the fact that the taxes dramatically increase the cost of them obtaining insurance. The Fire Services Levy is effectively a hidden tax, so not only should the system be rectified but the Australian public has the right to know that they are being taxed on insurance policies. The failure to acknowledge this is said to 'create a "fiscal illusion" effect whereby voters and taxpayers are uncertain about where the final instance of a tax falls

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<sup>61</sup> The measure for taxation efficiency is a multitude of various effects of the taxation and can only be discerned by looking at the way in which the taxation is collected, allocated and then distributed. Essentially I am advocating for a taxation regime which has minimal collection costs and which is allocated with distributive justice so that taxation does not impinge upon the ability of individuals to access insurance.

<sup>62</sup> Pettersen, above n 57, 4.

<sup>63</sup> Council Assisting, Submission to the Victorian Bushfire Royal Commission, *2009 Victorian Bushfires Royal Commission- Insurance and the Fire Services Levy*, 2009, 7.

<sup>64</sup> Public Accounts Committee, Parliament of New South Wales, *Public Accounts Committee- Review of Fire Service Funding* (2004) 53 – 64, 77 – 101.

<sup>65</sup> Counsel Assisting, above n 63.



and even how much revenue the tax raises.<sup>66</sup> Taxpayers have the right to know the amount of their tax liability. The current failure to apprise them demands particular attention to the flaws within our current system. There is a need for transparency and accountability in our taxation regime to create equilibrium between collecting tax revenue and promoting an efficient, stable and predictable taxation system which is concerned with the wellbeing of society as a whole. Part of the reform requires institutional change, and part requires a greater public knowledge. Increased awareness of the problems within our taxation system will enable valid criticism in order to promote accountability about the way state taxes are collected and spent.

#### ***D Fire Services Levy- The Fiscal Strength of Its Imposition***

Problematically, the way the Fire Services Levy applies as a means of taxing insurance policies does not increase the fiscal strength of the tax system. The legislation specifies a minimum taxation burden which must be divided. However, beyond this minimum amount any additional tax which an insurance company may inadvertently collect will not be added to the taxation revenue. Unfortunately the lessons of history have shown us that where there is an excessive amount of tax collected, the system enables any surplus to simply be a windfall gain contributing to the profitability of an insurer.<sup>67</sup> The fiscal strength of the taxation regime is therefore questionable; not only does it impinge upon the welfare of individuals, subjecting them to distorted costs, but also the government is potentially being robbed of taxation which is instead being absorbed as part of corporate profitability.

#### ***E Proposed Review- Victoria's suggested move away from the Fire Services Levy***

The current Victorian review of the funding system (Fire Services Levy) has been an opportunity for Victoria to rectify the current situation which fosters individuals being uninsured or inadequately insured.<sup>68</sup> The Institute of Actuaries of Australia has

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<sup>66</sup> Julie Novak, Kate Herbert and Sinclair Davidson, 'Business Bearing the Burden- The Size and Impact of State Government Business Taxes: The IPA State Business Tax Calculator', Institute of Public Affairs, December 2008, 4.

<sup>67</sup>Rachel Anne Carter, 'Wild Fires- The Legal Regulatory System of Insurance and Emergency Services Funding' (2011) 14 *Southern Cross University Law Review* 75, 75 – 92.

<sup>68</sup> Although it has been said on 27 August 2010 that the Fire Services Levy would be abandoned in place of a property based levy system operative on 1 July 2012.

See Andrew Main, 'Victoria Abolishes the Fire Services Levy on Insurance', *The Australian* (online) 28 August 2010 <<http://www.theaustralian.com.au/business/victoria-abolishes-fire-services-levy-on-insurance/story-e6frg8zx-1225911077603>> ; Jason Silverii, 'Fire Services Levy Abolition Long Overdue' (Media Release, 27 August 2010) 1 <[http://www.aar.com.au/med/pressreleases/pr27aug10\\_01.htm](http://www.aar.com.au/med/pressreleases/pr27aug10_01.htm)> ;

Despite the suggestion of change there is still great uncertainty about how this will work in practice and in fact uncertainty as to whether the plan to abandon the Fire Services Levy based upon insurance in favor of a property based levy will go ahead. Although a White Paper on the subject matter of the proposed change was due in February 2011, it still has not been released.

See Department of Treasury and Finance, 'Fire Services Funding Review' (2010) <[http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/RevisedToRPDF/\\$File/RevisedToRPDF.pdf](http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/RevisedToRPDF/$File/RevisedToRPDF.pdf)>

Furthermore, currently there has also been the failure to release the draft legislation as originally planned based upon the initial agenda for abolishing the insurance based levy system and instead opting for a property based system. The abolition of the Fire Services Levy and the exploration of different models are also not specifically listed as projects in which the Department of Treasury and Finance is currently involved.

commented upon the need for Victoria to abolish the Fire Services Levy in order to remove some of the prohibitive factors increasing the cost of insurance.<sup>69</sup> The importance of removing the Fire Services Levy in a timely manner can be quantified by the projected increase in adequate levels of insurability resulting from the cost reduction for obtaining insurance coverage. The 2009 Victorian Bushfires Royal Commission recognised the Fire Services Levy as impacting upon the levels of insurability and particularly, attributed to it the low levels of insurance coverage which many of the people most affected by Black Saturday had. One of the recommendations of the Royal Commission was therefore to change the taxation regime to facilitate more individuals to use insurance as an economic self-protection mechanism. Through cooperation between the government and insurers and the provision of monetary incentives for disaster resilient properties, the cumulative effect of this can result in a more disaster resilient society with fewer overall losses.<sup>70</sup> It was said that it is important to do things which help consumers obtain adequate levels of insurability where 'insurance is the ultimate community product and a key part of the nation's economic infrastructure, underpinning much of our national economic activity.'<sup>71</sup> The inequality of a small proportion of the Victorian people funding the emergency services of the whole state is, however, still a matter which needs to be addressed.<sup>72</sup> The ultimate question is how to strike the balance between ensuring sufficient funding for our services whilst minimizing onerous burdens on individuals and small businesses. Although it was claimed in late 2010 that there would be changes to the Victorian system in moving away from a system of imposing a Fire Services Levy on insurance premiums there has been no practical advancement. In particular there has not been any publicly released documentation or proposed regimes which could realistically form a new mechanism in the future for collecting the funding for the fire and emergency services in Victoria. The main problem in Victoria is that whilst there is a delay in promoting alternatives, the status quo remains - entrenching a system which due to its inherently high costs ensures that many are uninsured or inadequately insured. Essentially it is important that those who are uninsured or under-insured purchase insurance policies rather than 'rely heavily upon government and public assistance in the event of a disaster like the 2009 Victorian bushfires'<sup>73</sup> or after the

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Therefore it is still questionable whether the Fire Services Levy will actually be abandoned in practice or whether such promises were merely put onto the political agenda due to the impending state election at the time the comments were made.

See Editorial, 'Clarity Vital on the Fire Services Levy', *The Weekly Times* (online) 16 February 2011 <[http://www.weeklytimesnow.com.au/article/2011/02/16/296061\\_opinion-news.html](http://www.weeklytimesnow.com.au/article/2011/02/16/296061_opinion-news.html)>

<sup>69</sup> Institute of Insurance Actuaries, above n 33, 19.

<sup>70</sup> Commonwealth, 2009 Victorian Bushfires Royal Commission, *Final Report (Volume 2, Part 2- Fire Preparation, Response and Recovery)* (2010) 381 – 4.

<sup>71</sup> Mike Wilkins, 'Building Australia's Resilience to Natural Disaster' (Paper Presented at Address to CEDA, Sydney, 11 April 2011) <<http://www.cgu.com.au/cgu/news-media/cgu-insights/Pages/BuildingAustralia'sresiliencetonaturaldisaster.aspx>>

<sup>72</sup> Until the system is actually changed and the new change is implemented the insurance industry will continue to contribute more than \$500m per year towards providing funding for the Fire Services Levy. In the year ending 30 June 2011 the insurance industry in Victoria was contributing in excess of \$309m towards the funding of the Country Fire Authority alone. See Country Fire Authority, *Country Fire Authority Summary of Funding 2010*, 2010 [www.cfa.vic.gov.au](http://www.cfa.vic.gov.au). For corresponding figures for the Metropolitan Fire Brigade see Metropolitan Fire Brigade, *Metropolitan Fire Brigade Summary of Funding 2010*, 2010 [www.mfb.vic.gov.au](http://www.mfb.vic.gov.au).

<sup>73</sup> Insurance Council of Australia, 2009 Victorian Bushfires Royal Commission, *Insurance and the Fire Services Levy: Submissions of the Insurance Council of Australia Ltd* (April 2010) 4.

flooding in Victoria in 2011.<sup>74</sup> When the system abolishing the current Fire Services Levy is decided upon and implemented it should ensure that it promotes insurance as an essential protection for each individual in society to possess in order to protect their own economic interests.

Secondly, when devising the costing of insurance policies it is necessary that in the future there is an equal contribution of both horizontal and vertical fiscal equity imputed into the mechanism for pricing.<sup>75</sup> Furthermore in terms of pricing, consumers should be informed about how their policy is calculated and there should be a clear break-up of the different cost components of an insurance premium upon the policy notice.<sup>76</sup>

Rather than focusing upon the recovery phase from a disaster, ensuring that insurance is affordable and accessible to all would be a better way of equipping Australia to absorb and mitigate losses resulting from natural disasters. Greater research must be undertaken into providing affordable insurance to all people, particularly those for whom cost is currently a prohibitive factor forcing them out of the insurance market and thus potentially placing them in the precarious position of financial ruin if a natural disaster occurs. Methods under which the cost of insurance is easier to absorb must also be researched and different proposals suggested to better facilitate the uptake of insurance.<sup>77</sup> The formulation of possible alternatives to amend the current state tax regime in relation to the imposition of the Fire Services Levy upon insurance needs to be considered very quickly in order for it to be implemented in a timely fashion. Essentially, the tax regime with respect to state transactional taxes, particularly the Fire Services Levy, must keep in mind its impact, that 'almost two million Australian households are thought not to have insurance and it is likely that a larger number are under insured.'<sup>78</sup> Therefore removing the first level of cascading state taxes on insurance is the first step towards ensuring equilibrium and promoting insurability.

#### **V GOODS AND SERVICES TAX- WHAT VALUE IS ACTUALLY BEING ADDED TO A CONSUMER'S PRODUCT AS A RESULT OF INSURANCE?**

There are two separate problems with GST and its application to insurance policies. These are:

1. GST is added to an insurance premium after a Fire Services Levy has already been charged;
2. GST is a value added tax and thus should be calculated in this way, but it is not.

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<sup>74</sup> Although the flooding also occurred in Queensland in January 2011 and the scale of destruction was worse in Queensland, the insurance regulatory regime in Queensland is not premised upon having a fire services levy imposed upon an insurance premium.

<sup>75</sup> *Ibid.*

<sup>76</sup> It was recently recognised that there were problems within the insurance industry in informing consumers of what they are covered for and how their policy is ultimately calculated. See Wilkins, above n 71, 2.

<sup>77</sup> Rachel Carter, Submission No 1 to Senate Economics References Committee, Parliament of Australia, *Inquiry into the State Governments Insurance and the Flood Levy*, 13 April 2011, 1, 8.

<sup>78</sup> Wilkins, above n 71, 3.

One of the main benefits of GST is that because it is a Commonwealth based tax, it is levied at the same rate around Australia. Given that this is a federal based tax, it would be appropriate for this tax to be abolished which would to a degree alleviate the high levels of taxation on insurance. A token gesture by the Commonwealth to mitigate the harsh effect of 'cascading'<sup>79</sup> state taxes was that under s78-5(1),<sup>80</sup> the GST amount will not be levied against any stamp duty payable under an insurance policy. Although theoretically this minimises GST liability, in reality it simply means that stamp duty will be charged last so that it can be charged on both the Fire Services Levy (in Victoria and New South Wales where it is applicable) and on the policy amount inclusive of the GST. Although the effect of this is only a token gesture pertaining to the way that insurance is calculated, it is significant because this is a direct way of implementing Recommendation 56 of the HIH Royal Commission.<sup>81</sup> Implementing this recommendation is a great move. Given its success, why is the government now so hesitant to implement practical changes to the recommendation specified in the many governmental reports, including the Henry Review, detailing the problems with inefficient state taxes on insurance? The main problem with the changes adopted was that in light of the existing taxation burden, the changes to the GST regime were simply too little, too late. The problems with tax on insurance created an enormous burden that is not lifted by exempting from GST any amount of stamp duty payable.

The removal of GST from insurance premiums in its totality would be better suited to rectify the current problems. However an alternate suggestion is that if all of the state taxes (Fire Services Levy and stamp duty) were removed in their totality from insurance premiums, instead GST could be used as an alternate form of collecting revenue. Under this model there could only be one layer of taxation, being the GST, which would be applied at a uniform rate across a variety of goods and services. The existence of this system would render the need for other less efficient transactional taxes to be abolished.

In New Zealand in 1985 there was a move away from transactional taxes to a system whereby there was a GST imposed upon almost all goods and services. The effect of the taxation regime being based upon a more widespread GST regime meant that individual goods and services such as insurance were affected by fewer taxes; in fact there would only be one overarching tax imposed. The way the system in New Zealand operated has enabled the tax system to have a broad base, meaning that the taxation burden was more equally shared by the public generally. Furthermore, due to the GST operating as the overarching taxation system which is in existence, the costs of administering a broad based uniform GST in New Zealand have been relatively low, facilitating the maximum usage of the money collected.<sup>82</sup> Furthermore, in New Zealand there is great simplicity which in turn eliminates confusion consumers may have in relation to their taxation obligations and thus reduces the incidence of taxation evasion, maximising the

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<sup>79</sup> Justice Owen, Commonwealth, Royal Commission on the Failure of HIH Insurance, *Final Report* (2003), Part 3 [10.3.3].

<sup>80</sup> *A New Tax System (Goods and Services) Act 1999* (Cth) div 78.

<sup>81</sup> Justice Owen, Commonwealth, Royal Commission on the Failure of HIH Insurance, *Final Report* (2003), Part 3 [10.3.3].

<sup>82</sup> Marie Pallot and Hayden Fenwick, 'Recent GST Reforms and Proposals in New Zealand' (2000) 10 *Revenue Law Journal* 88, 88 - 90.

amount available for public expenditure. Perhaps it would be useful to use the model adopted in New Zealand for Australian purposes.

Although prima facie the New Zealand system looks relevant, it is essential to determine the differences between Australia and New Zealand to properly determine the viability of having such a system implemented in Australia. Essentially, the biggest difference would be the need for such a regime to be malleable in order to adapt to the Australian system, particularly due to the inherent political differences which aid the suitability of this taxation system within the broader New Zealand social and political system. Importantly, part of the success of the current regime can be attributed to the singular level governance regime. This facilitates greater ease of implementation than would be experienced in Australia, dealing with the constitutional limitations due to the federal/state divide. Furthermore, particularities to the New Zealand system that add to the effectiveness of the regime include political considerations and public input.<sup>83</sup> Furthermore, the creators of this taxation reform used the constitutional implications advantageously, culminating in the creation of a tax system now recognised globally for its efficiency. Through such considerations, New Zealand was able to create a system where low levels of taxes were charged, but due to the efficiency in the system the ultimate amount expended on the community was increased.<sup>84</sup> Problematically, the system cannot be directly transplanted into Australia due to the systematic differences between Australia and New Zealand. Australia should take a lesson from our neighbour and look at the benefits achieved through a broad based low rate tax reform.<sup>85</sup>

The changes to the GST system in New Zealand resulted in taxation being spread over a much broader base. Thus areas which had traditionally experienced piggyback style taxes were often enabled to provide goods and services more affordably, overall, than before the change. Therefore, due to the similarities between Australia and New Zealand, it is quite likely that if there was a change in the system whereby there were fewer taxes upon insurance, this may create an increase in the number of people who are insured and may be a good step towards the overall objective of ensuring that everyone is adequately insured. The changes in New Zealand are also attributed to creating a more equitable and stable taxation system.<sup>86</sup> Australia should follow its international counterpart and enjoy an efficient taxation system which focuses on equity, stability and predictability rather than the current focus which seems to be only on the amount of tax received. When looking at alternatives to the current system, the

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<sup>83</sup> Although many commentators have applauded the changes which occurred in New Zealand after the change towards a broader GST system, there have been criticisms of the system suggesting that rather than enhance the fiscal strength of the New Zealand taxation regime, the practical effect has in fact been to weaken it. See John Quiggin, 'Social Democracy and Market Reform in Australia and New Zealand' (1998) 14 *Oxford Review of Economic Policy* 76, 76 - 93.

<sup>84</sup>David White, 'Income and Consumption Taxes in New Zealand: The Political Economy of Broad- Based Low- Rate Reform in a Small Open Economy' in John G Head and Richard Krever (eds), *Tax Reform in the 21<sup>st</sup> Century* (Kluwer Law International, 2009) 95, 103 - 18.

<sup>85</sup> It has been suggested that, at least from a theoretical standpoint, the implementation of 'a broad base, low rate tax system provides a useful rule of thumb for an efficient tax system in practice' and that the implementation of this regime was at least initially 'rightly hailed by many at the time as a major improvement in New Zealand's tax settings.' See Norman Gemmill, 'Tax Reform in New Zealand: Current Developments' paper presented at 'Australian's Future Tax System: A Post- Henry Review' Conference, Sydney, 21- 23 June 2010, 4.

<sup>86</sup>White, above n 84, 103 - 18.



Commonwealth government should consider the option of co-operating with the states in order to disband inefficient state taxes in favour of a more widespread GST system which has less negative implications for consumers, particularly in relation to obtaining adequate levels of insurance.

### ***A GST Applied to Insurance***

Ideally GST should not apply to insurance policies at all, particularly in light of the other taxes which are already charged upon insurance premiums. It is however important to recognise the reality of the revenue which such taxes bring to a state whereby 'the States now accrued approximately one in twelve tax dollars from taxes on insurance.'<sup>87</sup> This is manifestly unfair for the insured. Furthermore, as GST is applied at a universal rate across Australia owing to it being a federal tax, there is a failure to provide vertical equity. Therefore those from lower socio-economic backgrounds have a higher tax burden proportionate to the amount they receive as income and thus insurance is even more burdensome than if absolute equity (in the full sense being horizontal and vertical equity) was applied. This is illustrated by the Australian Bureau of Statistics who suggest that consumers in the lowest and second quintile spend in the vicinity of 3.5% - 6% of the household income on insurance whereas those in the highest and fourth quintile on average spend only approximately 2% on general insurance.<sup>88</sup> The effect of the taxation varies due to the use of horizontal fiscal equalisation where the same tax rate is applied to all. In the case of insurance, the figures illustrate this has been problematic, indicating a consideration of socio-economic factors would be appropriate. The taxation rate should then be adjusted to recognise and rectify the silent factors which impinge upon access to insurance. Those from low socio-economic backgrounds are given a real disincentive to attain insurance due to the flaws inherent in the tax system. This should be rectified because forcing these people out of the insurance market is simply shifting the tax burden to others.

### ***B Adding Value to Insurance- How to Calculate GST on Insurance Policies***

The second reason for abolishing the GST on insurance policies is that the way it is calculated on insurance does not serve the objectives of a value added tax. In the insurance context, GST is usually not worked out on the basis of the value insurance adds to property. GST is charged on the policy cost. It is exceptionally difficult to discern the exact value added to property by virtue of insurance. Although theoretically possible for an insurance actuary to do this, it is not a practice which is adopted in Australia. Realistically using insurance actuaries to do this for each transaction would be counterproductive as it would lead to massive administrative costs therefore minimising any success achieved by such a reform. The outcome for insureds at the present is that they are forced to pay the full rate of 1/11<sup>89</sup> on the cost of the premium rather than the added value which insurance has to the particular property insured. The premise upon which GST was created was to levy a tax of 1/11 of the total value added to a good or service. Yet this is simply not done in practice due to complexity in the calculations to specifically determine the added value. Potentially the difference

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<sup>87</sup> Insurance Council of Australia, *Inquiry into State Government Taxation and Debt*, above n 13, 6.

<sup>88</sup> Australian Bureau of Statistics, 'Household Expenditure Survey: Summary of Results', 15 February 2006.

<sup>89</sup> *A New Tax System (Goods and Services) Act 1999* (Cth) div 78.



between the value added to insured property and imposing GST on the policy cost could lead to the collection of different amounts of taxation.<sup>90</sup> Given the actual value to the property is likely to be less than the total amount of the policy, there is a maximisation of the revenue collected at the expense of forcing some people out of the insurance market.

Tax efficiency is essential whereby rather than collecting more tax it would be better to minimise administrative costs and eradicate dead weight losses. If efficiency, transparency and accountability were applied at every step of the tax collection and expenditure process, less funds would be needed to produce the same outcomes. Rather than focusing upon maximising the revenue, there should be a pedagogical shift towards societal considerations. The efficient use of the taxation revenue would be the first step towards striking the precarious balance between revenue raising and adequate societal considerations of the tax regime.

## VI STAMP DUTY- RUBBING SALT INTO THE TAX WOUND

Stamp duty is the final layer of taxation which is imposed upon an insurance transaction. Stamp duty is a state based tax and therefore the range applied to insurance premiums is 8% to 10%.<sup>91</sup> The legislation in all states specifically enables stamp duty to be charged on top of existing insurance taxation; universally being GST and in Victoria and NSW also the Fire Services Levy - escalating the cost of insurance substantially. This effectively promulgates a tax on tax system.<sup>92</sup> The effect of this on the individual can be seen very clearly through the increase of 78% in the amount of stamp duty collected by most states after the introduction of the GST.<sup>93</sup> The real solution to stamp duty on insurance policies would be to have a total abolition, particularly given the problems it causes counteract the benefits derived from the collection of this taxation, leading to high levels of uninsurance and inadequate insurance. However if the states are not willing at this stage to create an abolition on collecting stamp duty, a substantial reduction in the rate of stamp duty is the minimum step that can be undertaken in the interim. The reduction if adopted should only be temporary pending a prompt removal of stamp duty in its totality from insurance policies. The current system is simply rubbing salt into the very deep tax wound which as it festers draws more people away from insurance and sucks more people into a position of potential helplessness. Stamp

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<sup>90</sup>For a general understanding of how GST can apply to insurance pay outs and how GST is dealt with in a business context, see JW Durack, 'GST and Insurance' (1999) 28 *Australian Tax Review* 189, 189 – 94.

<sup>91</sup> The amount of stamp duty varies between States. Please see the relevant rates from the specific state legislation below:

- *Duties Act 1999* (ACT) ch 8 (Rate of 10%);
- *Duties Act 1997* (NSW) ss 232(2), 234(1) (Rate of 9%);
- *Stamp Duty Act 1978* (NT) s 49B, sch 1, it 6 (Rate of 10%);
- *Duties Act 2001* (Qld) s 349 (Rate of 8.5% (Class 1 general insurance));
- *Stamp Duties Act 1923* (SA) sch 2, pt 1(1)(ab) (Payment of \$11 per every \$100 of policy or part of policy);
- *Duties Act 2001* (Tas) s 163 (Rate of 8%);
- *Revenue Ruling Pub-DT-2001-4*
- *Duties Act 2000* (Vic) s 179 (Rate of 10%);
- *Duties Act 2008* (WA) s 215 (Rate of 10%).

<sup>92</sup> *Ibid.*

<sup>93</sup> Insurance Council of Australia, *Inquiry into State Government Taxation and Debt*, above n 13, 6.

duty and other taxes are increasing the cost of insurance and this contributes to unacceptably high levels of uninsured and insufficiently insured individuals. We need to rectify this inequity and heal the wounds the current system has created, particularly amongst those who are the most disadvantaged within our society.

## VII ACHIEVING EQUILIBRIUM THROUGH PREDICTABILITY AND STABILITY

If state tax reform is to be effective and realistically considered for implementation, a solution must be proposed facilitating the sufficient funding and services of each state at a comparable rate to that which existed under the previous regulatory regime. Australia should no longer be subjected to 'world record levels of state and territory taxes',<sup>94</sup> particularly in Victoria which has the 'world's highest level of insurance taxes.'<sup>95</sup> This problem must be rectified for the people of Australia. One suggested solution was to impose a higher rate of GST uniformly and to have this money applied to the states in return for a continued abolition of inefficient state taxes such as those on insurance. The cost of running a State generally does not decrease. Therefore the provision of an amount necessary to fund the basic services and facilities of a society is essential. The best taxation system should possess transparency and accountability but in providing stability will need to be flexible enough to adapt to the needs of all Australians and the needs of those living in each State or territory.

Achieving the correct equilibrium requires efficiency in the use of funds, rather than the current tendency to retain inefficient transactional taxes. The use of transactional taxes evidences taxation becoming merely a numbers game, maximizing revenue without due consideration for the sociological concerns. This is particularly problematic when 'demand for house and contents insurance was negatively correlated to the price of insurance products.'<sup>96</sup> This also increases the cost to governments after loss bearing events. 'General insurance is integral to the functioning of an efficient and developed economy. Insurance monetizes risk and allows risk to be efficiently transferred across the economy.'<sup>97</sup> Therefore assessing and implementing change should be positioned as being of political and social importance with rectification required immediately. Simply playing a numbers game with tax affects the lives of individuals and the wellbeing of communities. The other adverse side effect of taxing as a game rather than through sound economic principles is the fact that the government is now exposed to potential liability of up to \$53.3 billion in uninsured property and up to \$48.4 billion in household contents due to problems associated with uninsured and inadequately insured individuals.<sup>98</sup> If a catastrophic event causes losses of this uninsured property, even if the government only helps finance a portion of the recovery, their liability will still be massive. It would be much better to tax in a manner affording the principles of equity and stability to end the vicious cycle of welfare dependency faced by those unable to pay for insurance. Insurance should not be about compulsion. However, the way insurance is taxed should not operate to make insurance products exclusive. We need to

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<sup>94</sup> National Insurance Brokers Association, above n 4.

<sup>95</sup> Ibid.

<sup>96</sup> Insurance Council of Australia, *Inquiry into State Government Taxation and Debt*, above n 13, 11.

<sup>97</sup> Ibid 3.

<sup>98</sup> Ibid 9.

stop taxing the taxed and encourage resilient communities rather than nurture a system fostering a vicious cycle of potential government dependency.<sup>99</sup>

### VIII TO THE FUTURE WITH FAIRNESS

Reforming the taxation system, although necessary, will not be an easy task. As the paper has shown it will be exceptionally difficult firstly to break through the constitutional impediments. Due to historical dominance<sup>100</sup> and the potential for the Commonwealth to put conditions on state expenditure; the states continue to be reluctant to disband inefficient state taxes in favor of a more centralized system. This is not simply a matter of state autonomy but rather goes to the heart of each state's financial interest whereby currently there is no guarantee that disbanding transactional taxes in favor of a more efficient national system would benefit the needs of the constituents of any particular state.<sup>101</sup>

It is very clear that our current tax on tax system is forcing many to be uninsured or inadequately insured.<sup>102</sup> The absurdity within the system is that although the Fire Services Levy (in NSW and Victoria),<sup>103</sup> the GST and stamp duty in all states can increase the cost of insurance policies by as much as 123%,<sup>104</sup> many taxpayers are oblivious to the fact that taxes have been imposed upon their insurance premiums. Consumers have a right to know that a large proportion of insurance premiums are comprised of a tax component. Greater public knowledge of the existent taxes would also ensure greater efficiency in the way funds are spent as well as transparency in the amounts raised. The public involvement would also act to ensure that the current taxation regime is not simply a numbers game, to maximize the revenue attained. Tax reform is however necessary to ensure that there is greater efficiency so that less taxation is charged on insurance premiums. Efficiency and stability would ensure that through a minimum amount of funding the best possible services and facilities can still be provided to the Australian public.

A key change must also come from within the taxation pedagogy whereby taxation must at all times be contextualized within the context of its sociological implications. It is important that the way the state taxation regimes operate facilitates choice within the insurance market. Consumers should not be forced to take the chance of being subjected to a cycle of government dependency simply because the cost of attaining insurance is financially disabling. The exclusivity of the insurance market due to the extraordinary taxation proponent is problematic. This is potentially subjecting the nation not only to instability but also potential indeterminate liability after catastrophic events. Given the current increasingly frequent and increasingly severe weather related disasters causing

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<sup>99</sup> Mortimer, Bergin and Carter, above n 19, 1; Council of Australian Governments, above n 19, 75 – 80.

<sup>100</sup> *Victoria v Commonwealth* (1926) 38 CLR 399, 417; *South Australia v Commonwealth* (1942) 65 CLR 373.

<sup>101</sup> Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', above n 7 46.

<sup>102</sup> Warren, *Fiscal Equalisation in Australia*, above n 51.

<sup>103</sup> Carter, 'Wild Fires', above n 67.

<sup>104</sup> Pettersen, above n 57, 1; Mendelson and Carter, above n 57.

loss,<sup>105</sup> the issue of taxation forcing people out of insurance is a real concern, something which needs to be rectified promptly.

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<sup>105</sup> Sullivan, above n 21, 42.

**TAXING PERSONAL CAPITAL GAINS IN AUSTRALIA –  
IS THE DISCOUNT READY FOR REFORM?**

JOHN MINAS\*

**ABSTRACT**

The 50 per cent Capital Gains Tax discount for individuals has become an entrenched feature of the Australian tax system, despite the fact that there was no promise of it being a permanent tax reform at the time of its introduction in 1999. Although the prospects for reform of the individual CGT in the immediate future appear limited, this paper compares a number of alternative options for taxing individual capital gains.

The paper argues that the CGT discount need not be considered a permanent tax change. The effects of the CGT discount should be subject to some empirical scrutiny in order to ascertain whether it is achieving its original objectives.

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## I INTRODUCTION

One of the justifications for a capital gains tax (CGT) is that from an economic perspective, there is no difference between a capital gain and ordinary income. This is consistent with the principle of horizontal equity which considers that taxpayers in the same economic circumstances should incur the same tax liability and that the source of an accretion in wealth should not determine tax liability. CGT is also used to maintain the progressivity of the overall tax system and can therefore be justified according to vertical equity principles whereby a taxpayer's liability for tax should be determined by their economic ability to pay. Higher-income taxpayers receive a larger proportion of their income in the form of capital gains and they generally have a lower ratio of consumption to total income.<sup>1</sup> Taxation statistics for Australian individual taxpayers confirm that the majority of capital gains are realised at the highest levels of individual income. In the 2007-08 financial year, the proportion of total capital gains realised by Australian individual taxpayers with a taxable income over \$150,000 (taxpayers in the top 2.7 per cent of the income range) was 51.5 per cent.<sup>2</sup> In the same year, 72 per cent of net capital gains were realised by taxpayers with a taxable income of over \$75,000 (the top 12.9 per cent of taxpayers by reference to income).<sup>3</sup>

The Australian CGT was introduced in September 1985 to replace the limited system of taxing capital gains that had been in operation prior to this time, under sections 25A and 26AAA of the *Income Tax Assessment Act 1936*.<sup>4</sup> The pre-1985 capital gains tax provisions proved to be ineffective by virtue of their limited application and there was consequently an incentive for taxpayers to re-characterise income as capital as a tax avoidance technique. The 1985 Capital Gains Tax acted as an integrity measure which improved vertical and horizontal equity and broadened the tax base.

In 1999, the Ralph Review of Business Taxation recommended a major reform to the individual CGT in the form of the 50 per cent CGT discount. The CGT discount permits specified taxpayers to include in their taxable income only 50 per cent of a capital gain from assets held for at least twelve months. This significant preference for capital gains, effectively a rate reduction, was justified by the Ralph Review on the basis that it would achieve a number of objectives including: enlivening and invigorating the Australian equities markets, stimulating greater participation by individuals and achieving a better allocation of Australia's capital resources.<sup>5</sup> Given that rate preferences for CGT are damaging to the vertical and horizontal equity aspects of the tax,<sup>6</sup> equity concerns may have been perceived as relatively unimportant by those who argued in favour of the introduction of the CGT discount.

The Ralph Review failed to explain either how the CGT discount rate of 50 per cent was determined or whether it was intended to be a permanent or temporary reform. Despite

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<sup>1</sup> Jane Gravelle, *The Economic Effects of Taxing Capital Income* (The MIT Press, 1994)13.

<sup>2</sup> Australian Taxation Office, *Taxation Statistics 2007-08* (2010).

<sup>3</sup> Ibid.

<sup>4</sup> Capital Gains Tax is not strictly a separate tax in Australia, although it is commonly referred to as CGT.

<sup>5</sup> Australian Treasury, 1999, *Review of Business Taxation, A Tax System Redesigned* 598.

<sup>6</sup> Chris Evans, 'Curing Affluenza?: A Critique of Recent Changes to the Taxation of Capital Gains in Australia', (2000) 23(2) *University of New South Wales Law Journal* 299, 301.



this, the 50 per cent CGT discount has acquired a de facto permanent status due to the reluctance at the Federal Government level to change the rate of CGT discount. In 2010, the former Rudd Government ruled out any change to the CGT discount despite the recommendation of the Henry Review to lower the CGT discount rate to 40 per cent.<sup>7</sup> The decision to rule out this reform was made in a relatively short period of time and it was not accompanied by detailed reasoning on why the reform was not considered to be viable. That a 40 per cent CGT discount was ruled out, rather than included in the reforms to be considered over the longer term, suggests that political considerations may have trumped tax policy considerations on that occasion.

Notwithstanding that there are a considerable number of arguments to be found for full rate CGT in the literature, in practice many tax jurisdictions offer tax preferences for capital gains, whether these are in the form of discounts, exclusions, exemptions or low rates relative to ordinary income. Although CGT rate preferences are also used in comparable tax jurisdictions such as the United States and Canada, they are unlikely to have their justification in rate competition, since capital is not highly mobile at the individual taxpayer level. The CGT discount has been criticised by some tax experts on the grounds that it is open to abuse and that its enactment was a retrograde tax policy move.<sup>8</sup> The impetus for reforming the Australian individual CGT arises from these unaddressed criticisms of the CGT discount and from the fact that it may not be achieving its intended policy goals.

## II THE NEED FOR REFORM

Deciding the rate at which to set a CGT is based on value judgments about equity.<sup>9</sup> Despite the lack of a clearly articulated policy reason for the introduction of the Australian CGT discount, CGT rate preferences in general are usually justified based on arguments about increases in economic efficiency and entrepreneurship and the reduction in the lock-in effect that they may lead to. To date, there has been a lack of empirical evidence about whether the CGT discount has achieved such outcomes. The case for a lower rate of capital gains tax encouraging entrepreneurship and risk taking is a somewhat unconvincing one, given that there are a range of other factors that have an influence on decisions to invest. The CGT rate that will apply at the time a capital gain is realised is unlikely to be the most prominent influence on investment decisions, especially since CGT is not payable at the time the investment is made.

The CGT discount appears to be a poorly targeted measure for achieving entrepreneurship and risk-taking, since it does not favour riskier types of investments relative to other types of investments. Generally, a capital gains tax can encourage risk-taking by reducing the variation in return even though it also reduces expected return.<sup>10</sup> Furthermore, the interaction of the CGT discount and interest deductibility can lead to distortions to efficiency. Deduction of interest at full, non-discounted rates, can act to encourage investment in assets that are economically inefficient insofar as they would

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<sup>7</sup> Ken Henry, *Australia's future tax system : report to the Treasurer* (2009) Commonwealth of Australia.

<sup>8</sup> John Head and Richard Krever. 'Taxing capital income' (2007) 22 (2) *Australian Tax Forum*, 81,89.

<sup>9</sup> Jon Kesselman, 'Capital Gains Taxation: Augmenting the Reform Report' (2005) *Tax Notes* 1687.

<sup>10</sup> Gravelle, above n 1.

be loss making in the absence of tax considerations.<sup>11</sup> This significant efficiency cost appears to have been disregarded by policymakers when the decision was made to introduce the CGT discount.

In deciding how, or at what rate, to tax individual capital gains, all competing tax policy trade-offs should be considered and weighed up, including the distributional effects, rather than focusing on one particular effect of a change in the individual CGT regime. CGT is an important component of the overall personal income tax system and its operation and effects should therefore be evaluated in the context of the overall tax system.

Prior to the introduction of the CGT discount, one of the main focuses of the debate concerning the reform was the potential revenue effects. Revenue effects have been the cornerstone of the debate in the United States about CGT rate changes and they have been referred to extensively in the literature.<sup>12</sup> There is an argument that since revenue effects are only one aspect of CGT policy, they should not be given too much weight in determining whether a CGT rate preference is necessary. Reasons for this include that revenue effects cannot be predicted with certainty, they are unlikely to be large and a higher revenue yield can be better achieved through deemed dispositions on death rather than through CGT rate changes.<sup>13</sup>

The argument that the lock-in effect is an important factor in capital gains realisation decisions is based on an assumption that the rate of CGT is of high importance to investors. The lock-in effect may, in fact, not be important to the majority of capital gains realisation decisions and would not apply in forced realisation decisions or realisation for consumption. The literature identifies the lock-in problem as applying mostly to the sale of corporate shares and only to a small proportion of total sales.<sup>14</sup>

### III ALTERNATIVE WAYS OF TAXING CAPITAL GAINS

#### *A Restore Full Rate Capital Gains*

The rate at which capital gains should be taxed is based on economic efficiency assessments and revenue effects.<sup>15</sup> Taxing capital gains preferentially is essentially a compromise between creating incentives for saving and entrepreneurship against forgone tax revenue.<sup>16</sup> Part of the Ralph Review's justification for the introduction of the

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<sup>11</sup> Leonard Burman, 'Taxing Capital Gains in Australia: Assessment and Recommendations', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 113, 121.

<sup>12</sup> For example the view that there is little reason to believe that a reduction in capital gains tax would increase revenue can be found in Alan Auerbach, 'Capital Gains Taxation and Reform', (1989) 42 3 *National Tax Journal* 391. Whereas the view that reducing the tax on capital gains would increase tax revenue can be found in Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, 'The Effects of Taxation on the Selling of Corporate Stock and the Realizations of Capital Gains' (1980) 94 4 *Quarterly Journal of Economics* 790.

<sup>13</sup> Richard Krever and Neil Brooks. *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, 1990) 70-71.

<sup>14</sup> *Ibid* 71.

<sup>15</sup> Kesselman, above n 9.

<sup>16</sup> *Ibid*.

50 per cent CGT discount was that CGT revenue would increase due to a reduction of the lock-in effect resulting in increased CGT asset realisations. However, this is a flawed justification for the CGT discount given that research from the United States has shown that a large reduction in the rate of capital gains tax is unlikely to be self-financing in the long run.<sup>17</sup>

One of the main weaknesses of the CGT discount is that it restores the incentive for taxpayers to engage in tax arbitrage behaviour, whereby income is re-characterised as capital. This type of tax arbitrage may have a negative impact on efficiency by lowering tax revenue and requiring governments to increase the rate of other distortionary taxes.<sup>18</sup> It was a conclusion of the Ralph Report that the introduction of the CGT discount was intended to induce behavioural responses and that their size and revenue effects would be difficult to estimate.<sup>19</sup> The implications of tax arbitrage should be part of a model that attempts to estimate the effects of capital gains taxation and such a model should, as much as possible, attempt to distinguish between the different motives for realising capital gains.<sup>20</sup> Although the encouragement of tax arbitrage is not an explicit objective of lowering the rate of capital gains tax, it can be a significant side-effect of such a measure. Under the CGT discount regime, a proportion of realised capital gains are due to an arbitrary conversion of income to capital rather than from an unlocking effect on gains that would not have been realised had the previous higher effective rate of CGT applied.

Another consideration that would apply to the reintroduction of full rate capital gains is whether to allow indexation of the cost base of CGT assets. The main argument in favour of indexation is that inflationary gains should not be subject to tax. However, the case for indexation is difficult to support if it only applies to one component of the tax system. Indexation can be considered more complex compared to a discount, but the latter is by no means an adequate substitute for indexation given that the rate of discount is not dependent on the timing of the realisation, except for the minimum holding period of twelve months. Whatever its merits, it would seem that the reintroduction of full rate capital gains in Australia is an unlikely event in the near future given the rejection of the Henry Review's recommendation to implement a minor change in the rate of CGT discount.

### ***B Adopt the Recommendations of the Henry Review***

The Henry Review recommended lowering the CGT discount to 40 per cent and applying this same rate of discount to other forms of non-labour income such as interest.<sup>21</sup> Although this recommendation does not remove the incentive for taxpayers to re-characterise ordinary income as capital, it removes the preference for capital gains relative to other forms of non-labour income that currently exists.

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<sup>17</sup> Leonard Burman, *The Labyrinth of Capital Gains Tax Policy*, (Brookings Institution Press, 1999) 58.

<sup>18</sup> Alan Auerbach & James Poterba, 'Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric' (1998) 2 *Brookings Papers on Economic Activity* 595.

<sup>19</sup> Parliament of Australia, Senate, 1999. Inquiry into Business Taxation Reform.

<sup>20</sup> *Ibid.*

<sup>21</sup> Henry, above n 7.

Part of the Henry Review's rationale for the recommended 40 per cent discount rate was that it was intended to act as an adjustment for the effects of inflation.<sup>22</sup> The use of a discount as a proxy for indexation achieves greater simplification with a rough approximation of an inflation adjustment, but still fails to correct for the benefits of long-term deferral of capital gains. The Henry Review also argued that a 40 per cent discount for the taxation of savings would counteract the tax wedge on future consumption that discriminates against those taxpayers who choose to save and reinvest and who incur a higher lifetime tax liability by doing so.<sup>23</sup>

If the Henry Review recommendation of a reduced CGT discount were implemented it would provide an opportunity for an elasticity study to observe the effect of a CGT rate change on asset realisations and CGT revenue. Elasticity in the CGT context is the percentage change in capital gains realisations divided by the percentage change in the CGT rate. The literature distinguishes between elasticity of capital gains realisations due to permanent tax changes and the transitory response due to temporary tax changes.<sup>24</sup>

For the purposes of an elasticity study, the current 50 per cent CGT discount could be considered a permanent tax rate since there was no lead time prior to its introduction, which would have allowed investors to time their realisation to obtain the best available effective tax rate. In the event that a new lower discount rate was announced along with a future date at which the 50 per cent CGT discount would cease operation, there would be some transitory effects to observe, related to taxpayers realising capital gains at a lower effective CGT rate now, with the knowledge that capital gains would be taxed at a higher rate in the near future. Distinguishing between permanent and transitory effects has important implications for measuring long term elasticity accurately. Behavioural responses that are due to transitory effects should not be included in the measurement of the permanent response to a CGT rate change.

The revenue effects of the Australian CGT discount could be evaluated by measuring elasticity using tax return data from a number of years preceding and following the introduction of the 1999 CGT discount. If the magnitude of the lock-in effect and elasticity as predicted by policymakers who oversaw the introduction of the CGT discount was found to be overstated, it would be appropriate for the recommendations of the Henry Review to be implemented as an incremental step toward further reducing the individual CGT discount.

### ***C Introduce Taper Relief CGT***

A taper relief system provides a progressive lowering in rates of CGT, or of the amount of capital gain to be included in assessable income, according to the length of time that an asset is held before disposal. Given that several different rates of CGT apply under taper relief, it is more complex than the current CGT regime. The introduction of a taper relief system would provide an opportunity for tax policymakers to increase the minimum holding period required for a capital gain to qualify for a discounted effective

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<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Leonard Burman and William Randolph, 'Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data', (1994) 84(4) *The American Economic Review* 794.

CGT rate. An increase in the minimum holding period would address concerns about the current 50 per cent discount being too generous a preference in cases where the asset holding period is only marginally more than twelve months. There is currently an incentive for investors to time the realisation of capital gains shortly after twelve months of holding the asset. Notwithstanding the benefits of deferral applying to capital gains, timing a realisation in this manner under the current CGT regime ensures that the investor gains the maximum benefit of the 50 per cent discount.

A potential negative effect of a taper relief system is that it could increase the duration of the lock-in effect, depending on the elasticity of capital gains asset realisations. If the elasticity of capital gains asset realisations is high, taxpayers, being sensitive to CGT rates, would elect to retain their asset for the time required to qualify for the lowest possible CGT rate. Another argument against taper relief is that providing a higher level of discount according to the length of time an asset is held can be seen as counter to the benefits of deferral that apply to capital gains.

#### ***D Retain CGT Discount but Remove Minimum 12 month Holding Period***

Most of the arguments in the literature for removing asset holding periods that are required for taxpayers to obtain the CGT rate preferences relate to economic efficiency concerns. The case for removing the 12 month holding period appears to relate more to liquid assets such as company shares rather than illiquid assets such as real property.

The inefficiency relates to decisions investors make about realisations; that is, although in some cases it may make economic sense for an investor to sell shares within a year of acquisition, they may instead choose to hold the asset for more than a year merely to qualify for the CGT discount. Notwithstanding the arguments about an asset holding period discouraging investors from changing their investment portfolios, the overall case for a 50 per cent CGT discount without a minimum holding period seems difficult to support given the high level of preferences that currently exist for capital gains.

The current 50 per cent CGT discount fails to achieve asymmetry between the treatment of capital gains and losses in a way that has not received a great deal of attention. This specific asymmetry problem occurs because taxpayers can realise capital losses on assets which have been held for more than 12 months, which can be offset against capital gains on assets that have been held for less than 12 months. A more symmetrical treatment would be to subject taxpayers' capital losses on assets held for more than 12 months to the same 50 per cent discount treatment as their capital gains. This measure would make no difference to the current tax treatment of offsetting capital losses against discount capital gains. However, it would result in a higher amount of CGT payable where the capital loss is used to offset a capital gain that is not eligible for the CGT discount, since the taxpayer would be required to only offset half their capital loss.

Although such a proposal would improve symmetry, it could have an adverse effect on efficiency. Although there is nothing unusual about an investor disposing of loss making assets within a 12 month period, under the proposed change, there would be an additional incentive for investors to do so, to be able to utilise the full amount of the capital loss. This added distortion is another argument for removing the minimum 12

month holding period. However, a disadvantage of a discount without a minimum holding period is that taxpayers would effectively be obtaining the benefit of a substitution for indexation even where the holding period was too short to justify receiving this.

Irrespective of any efficiency arguments for removing the minimum 12 month asset holding period for the CGT discount, this measure is unlikely to be adopted in Australia.

The benefits of deferral are such that any reform related to changing the 12 month holding period should be concerned with extending the amount of time that the asset must be held in order to qualify for the discount. In practice a taper relief scheme may be the best practical way of achieving this.

#### IV CONCLUSION

Much of the difficulty associated with determining the most appropriate way of taxing individual capital gains arises from the fact that CGT is a tax that can be avoided or postponed for a long period of time. Despite the benefits of deferral of capital gains being well documented in the literature, the current political environment is one where policymakers appear reluctant to implement changes to CGT that would result in higher effective CGT rates. The debate that preceded the introduction of the CGT discount was, in part, concerned with the effect that a CGT rate decrease would have on revenue. Unfortunately, those who advocated the 50 per cent CGT discount did not address the question of what was the most appropriate discount rate. How a CGT discount rate of 50 per cent was chosen is largely an unresolved question.

The reform of the CGT is a tax policy goal which appears to have been underestimated by some policymakers in terms of its importance as an integral part of the overall tax system. The introduction of the 50 per cent CGT discount was a piecemeal reform that effectively ignored some of the important effects on the overall personal income tax system. The large decrease in the effective CGT rate should not be accepted as a permanent tax policy change without verification and analysis of the predicted effects on the revenue and on the overall tax system. For example, the CGT discount combined with the deductibility of interest at full rates, can act to distort investment decisions by providing a tax preference for otherwise loss making investments. It would be remiss of tax policymakers to completely ignore this outcome as being not part of 'CGT reform' per se, since it was specifically the change to the effective CGT rate that gave effect to this anomalous outcome.

The tax policy merits of the CGT discount are questionable given the policy change was not justified according to traditional optimal tax policy criteria. The introduction of the CGT discount may have been more grounded in political considerations than good tax policy. Consequently, the optimal rate at which to tax capital gains is an unresolved question for tax policymakers in Australia and one which should be subject to further debate and scrutiny. For now, a decrease in the rate of CGT discount, as recommended by the Henry Review, should be part of the tax reform agenda.

The future CGT policy reform agenda should be aligned with the justifications for the introduction of the original Australian CGT in 1985. Reform of CGT related to changes in the rate of the CGT discount should be considered in view of the benefits of deferral that



apply to the taxation of capital gains. The deferral benefits reduce effective tax rates on capital gains compared to other forms of non-labour income.

There is an apparent need for an empirical study that determines the elasticity of capital gains realisations in Australia. Such a study would act to confirm or disprove the predicted revenue effects of the CGT discount, which appear to have been a strong influence on the decision to introduce the CGT discount. A review of the parliamentary debate prior to the introduction of the CGT discount demonstrates that policymakers deferred to the view that a rate reduction in CGT necessarily leads to an increase in revenue. If policymakers consider revenue effects important in determining the effective CGT rate, future policy decisions on capital gains tax reform should be influenced by empirical studies that use Australian data to determine what the revenue effects are rather than what they are expected to be. An Australian study on elasticity would further inform the debate on how to best tax individual capital gains.

## **TRACK A TO E ALPHABET SOUP: JOHN RUSSELL'S STILL COOKING!**

ALISTAIR HODSON\*

### **ABSTRACT**

John George Russell is well known in the New Zealand tax community as the creator and defender of the 'Russell tax template', developed in the 1980s and described as a mechanism to turn the 'water' of taxable receipts into the 'wine' of untaxed gains. Template related issues are still being litigated some three decades later. There have been well over 80 cases related to the template covering both substantive and procedural issues. Mr Russell has had limited success on procedural grounds claiming his wins have been the result of good luck more than anything else. He strongly claims Inland Revenue has run a vendetta against him for many years. He has possibly received more section 17 Tax Administration Act 1994 notices to furnish information than any other taxpayer in New Zealand, receiving 101 notices in one day alone!

Inland Revenue has taken several different 'tracks' when assessing various parties it considered received the tax advantage from the template. The 'tracks' used to assess various parties are also regarded by Mr Russell as a vendetta tactic. Ultimately the litigation has led to 'Track E' with Inland Revenue personally assessing Mr Russell for tax, penalties and interest totalling in excess of NZD \$138 million. A High Court decision found for Inland Revenue and confirmed Mr Russell's personal tax assessment. Mr Russell has been granted leave to the Court of Appeal. He states that if 'Track E' fails for Inland Revenue they will invent a 'Track F'.

One of the least known postures of the Compliance Model is that of the 'game player'. It would appear that Mr Russell has many tendencies attributed to a person classified under this Model's framework to be a classic game player. This paper attempts to provide an overview of arguably Inland Revenue's most litigious taxpayer and asks whether Inland Revenue are now on 'track' to a conclusion.

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## I INTRODUCTION

John George Russell is well known in the New Zealand tax community as the creator and defender of the 'Russell tax template', developed in the 1980s and described as a mechanism to turn the 'water' of taxable receipts into the 'wine' of untaxed gains. Template related issues are still being litigated some three decades later. There have been well over 80 cases related to the template, covering both substantive and procedural issues. Mr Russell has had limited success on procedural matters claiming his wins have been the result of good luck more than anything else. It may be easy to dismiss Mr Russell as having been 'yesterday's news' in the world of (alleged) tax avoidance with the more recent and significantly larger risk to the revenue of *Ben Nevis*<sup>1</sup> and the structured finance litigation.<sup>2</sup> Mr Russell still battles Inland Revenue after thirty-something years, although some of his earlier optimism of substantive litigation success may now be fading.

The personal strength required to prepare for and engage in 'battle' with Inland Revenue can easily be overlooked. This paper attempts to provide a brief background of how Mr Russell became engaged in the template litigation, as well as providing his reasons for the justification of his actions. Section II provides a brief background of Mr Russell and the 'rise and fall' of the Securitibank; the pre-template years. This section also briefly discusses the *Challenge* case where the liquidator of Securitibank sought to find a buyer for the substantial accumulated tax losses of one of the Securitibank companies, initially gaining Inland Revenue approval to do so. The formation of Commercial Management is also discussed. Section III discusses and briefly explains the Russell template. This section also provides a brief background of the Millers and O'Neils. The *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC) case is perhaps the most well known of all the template litigation. Section IV examines the different 'tracks' used by Inland Revenue to assess the tax liability arising from the template transactions. Track E, which assesses Mr Russell personally for a substantial amount of income derived from the template scheme led to an allegation of bias being raised, and an unsuccessful judicial recusal application, discussed in section V. Section VI considers the validity of Mr Russell's claims of a vendetta being directed towards him by Inland Revenue including two cases where allegations of impartiality, unnecessary obstruction and managing a trial by calling the wrong witnesses were advanced. Section VII provides a glimpse of the concerns held by Inland Revenue that led to the formation of a specific 'Russell tax avoidance team.' Section VIII considers the Inland Revenue Compliance Model and its application to Mr Russell. This section also discusses the 'game player' posture of the Compliance Model. Section IX, the conclusion, examines whether the litigation is drawing to a conclusion to allow Inland Revenue to 'move on' and allow Mr Russell a 'peaceful' retirement.

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<sup>1</sup> *Accent Management Limited v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027, *Accent Management Limited v Commissioner of Inland Revenue* [2007] NZCA 230; (2007) 23 NZTC 21,323, *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue* [2008] NZSC 115; [2009] 2 NZLR 289; (2009) 24 NZTC 23,188.

<sup>2</sup> See for example *BNZ Investments Limited v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582.

## II THE PRE-TEMPLATE YEARS

### A *The Early Years*

Mr Russell grew up in Hamilton and was just a usual 'country lad' growing up on a farm. Academically he succeeded well at both school and college. Initially when enrolling at college he had intended to study engineering with a view to take over the family farm, as his father had envisaged. An enrolment error led to him attending introductory accounting classes which he enjoyed immensely. Although perhaps disapproving at first, his father ultimately agreed that he should continue studying the accounting discipline. Mr Russell became both a Chartered Secretary and a qualified accountant. He worked as an accountant for some well known New Zealand companies at the time, such as L J Fisher & Co. Limited, Lamson Paragon (NZ) Limited, and Butland Industries Limited. These companies were all leaders in quite different industries; building and construction, printing, and food manufacturing.

The promise of a very large pay rise saw Mr Russell relocate to Auckland and enabled him to marry Melva; together aged 20 and 21 respectively they started married life in Onehunga, Auckland. Mr Russell's chosen field of study had led him initially into a successful career of cost accounting, however he then went on to become a leading figure in the formation of the emerging money market in New Zealand.

### B *The Rise and Fall of Securitibank*

*'...what was happening really is we were stretching the rules...we were within the rules but they were really being stretched...without people doing that you don't get any development...'<sup>3</sup>*

Short Term Deposits Limited was established by an Auckland share broking firm with Mr Russell being its first employee. The shareholders of Short Term Deposits Limited were all major New Zealand insurance companies. After receiving only minimal training for two weeks in Australia Mr Russell began operating out of a small one room office in central Auckland, assisted only by a typewriter. Short Term Deposits Limited was licensed as an official short term money market dealer and such was a very restricted license. Short Term Deposits Limited had 'lender of last resort' facilities with the Reserve Bank which was similar to the commercial banks. Initially people were cautious with regard to Short Term Deposits Limited, being used to previously only dealing with established banks.

Mr Russell travelled the length of New Zealand promoting the new business, competing with the banks for depositor's funds, and taking on speaking engagements to promote the new business. Short Term Deposits Limited saw an opportunity of expanding into other instruments like Bills of Exchange. Another company, Secured Deposits Limited was set up to take deposits with a minimum of \$1,000 and provide Local Authority Stock as well as Government Stock as security.

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<sup>3</sup> Interview with Mr John Russell, Christchurch, 27 July 2011.

Securitibank Limited was set up as a holding company. The shares in Short Term Deposits Limited and Secured Deposits Limited were transferred to Securitibank. Securitibank then created its own merchant bank, Merbank, to provide facilities for the Bill market. Securitibank expanded very quickly and in 1976 had approximately \$100 million dollars in the Bill market. The Securitibank Group became very exposed in a falling property market and this ultimately led to its collapse in 1976.

The shareholders of Securitibank voluntarily placed the company into liquidation, with liquidators appointed. Ultimately every creditor was paid in full, with a surplus distributed to some of the Bill holders by way of a Court order. Mr Russell was 41 years of age at the time of the collapse.

Securitibank was located on Queen Street in central Auckland. Mr Russell worked up to an estimated 100 hours a week, indicative of his personal stamina. Merbank, the company initially named and registered by Mr Russell, was one of the companies in the Securitibank Group involved in the case which led to the Privy Council decision in *CIR v Challenge Corporation Limited* (1986) 8 NZTC 5,219, a major contributor to New Zealand tax avoidance jurisprudence at the time.

### **C Tax Avoidance in the 1970s - The Challenge Case**

A well known New Zealand tax case is *CIR v Challenge Corporation Limited* (1986) 8 NZTC 5,219 (PC).<sup>4</sup> Challenge Corporation Limited entered into arrangements to purchase the shares of two loss companies with accumulated losses, relying on a particular Income Tax Act provision. Neither loss company traded after Challenge Corporation Limited had acquired them. This case led to subsequent legislative amendment preventing a similar *Challenge* arrangement and outcome arising. What is interesting about this case is that at the time of the Securitibank liquidation, a tax advisor (Mr William Wilson) to the then liquidator of the Securitibank Group was asked to investigate whether shares in one of the companies<sup>5</sup> involved in the Securitibank collapse, which had incurred a substantial loss for the year ending 31 March 1978, might attract a buyer on the basis that although insolvent, its large tax loss might be an attraction to a purchaser in a profit position. After approaching a number of major public companies without success, Mr Wilson interested a profitable Challenge Corporation Limited in purchasing the shares. The principal difficulties foreseen by Mr Wilson in the negotiations related to s 188<sup>6</sup> and s 191<sup>7</sup> of the *Income Tax Act 1976* (NZ) (ITA 1976) in force at the time.

Mr Wilson wrote to the District Commissioner of Taxes in Auckland on 28 November 1977, setting out the basis proposed for the transaction and seeking his comments. In a letter dated 3 March 1978, a senior examiner from Inland Revenue at Lower Hutt, Mr Paganini, advised Mr Wilson of his views of the particular transaction and approval to

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<sup>4</sup> *Challenge Corporation* [1986] 2 NZLR 556 contributed to the judicial development of s 99 *Income Tax Act 1976* (NZ) (the general anti-avoidance provision) equivalent to s BG 1 where the Privy Council made it clear that s 99 was of a general application and may apply notwithstanding that specific anti-avoidance provisions exist within a particular section.

<sup>5</sup> Kelmec Property Consultants Limited, a subsidiary of Merbank Limited (in liq).

<sup>6</sup> Section 188 *Income Tax Act 1976* (NZ) [Losses incurred may be set off against future profits].

<sup>7</sup> Section 191 *Income Tax Act 1976* (NZ) [Companies included in a group of companies].

proceed. Later, this transaction was 'challenged' by Inland Revenue when they changed their view on the tax consequences of the transaction.<sup>8</sup>

Mr Russell stated of the *Challenge* case:

'Merbank was one of mine...I wasn't involved in the sale to Challenge but they [Inland Revenue] used to approve these transactions all the time...in fact \$10,000 plus half the tax benefits was the "going rate" ...'<sup>9</sup>

### **D The Formation of Commercial Management**

After the well publicised Securitibank collapse, being the largest corporate collapse in New Zealand history at the time, Mr Russell claimed it was difficult to find employment opportunities and this led him to start Commercial Management Limited, initially run out of a small office in Upper Queen Street, central Auckland and ultimately run out of his family home in Pakuranga.

Mr Russell stated:

'There was no point really in applying for a job anywhere...while you are successful you are a financial genius, if you are unsuccessful you are a crook...that is basically the way you are looked at in New Zealand'.<sup>10</sup>

Mr Russell further stated that he had 'quite a few people come along to me and want me to rescue their businesses and all that sort of thing...'<sup>11</sup> He considered that if half the businesses that came his way could be turned around and saved, that was a very good percentage. So Commercial Management Limited began in 1977 with just a few clients and experienced rapid growth.

Mr Russell placed some initial advertisements in the *Accountant's Journal*,<sup>12</sup> never having placed an advertisement in a newspaper. He soon found that he could not handle the volume of work, as 'word of mouth' recommendations flourished. He shifted Commercial Management Limited from the Upper Queen Street premises to his home at Pakuranga. Having had five children, the Russells had purchased this house in 1971. It had seven bedrooms and as children left the home to go flatting or get married Mr Russell 'speedily converted their room into an office!'<sup>13</sup> Six rooms were converted into

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<sup>8</sup> The Commissioner is under a statutory duty to discharge his responsibilities, he cannot waive or suspend the application of the law unless he is vested with the statutory duty to do so and estoppel cannot be raised against him: CCH New Zealand Limited, "Commissioner's duties", *New Zealand Master Tax Guide*, (Auckland, 2010), [1-520].

<sup>9</sup> Interview with Mr John Russell, Kawakawa Bay, 27 January 2010.

<sup>10</sup> Interview with Mr John Russell, Kawakawa Bay, 27 January 2010. Mr Russell on occasion would give lunchtime addresses to the Auckland business community, his speeches being well reported.

<sup>11</sup> Interview with Mr John Russell, Kawakawa Bay, 27 January 2010.

<sup>12</sup> The New Zealand Society of Accountants (NZSA), now the New Zealand Institute of Chartered Accountants (NZICA) member magazine.

<sup>13</sup> Mr Russell displays his sense of humour during our interview of 27 January 2010 by saying that it was hard to convince his wife of the need for the additional room as an office at one stage saying 'Look Melva, we have got to do this because (1) we need it for the business, and (2) if we don't, they [the children] might come back!'



offices and a lounge was used for meetings with clients. The business was very well organised with a booking system for the meeting room (the lounge) initiated and daily lunch provided by Mrs Russell for all the staff. Mr Russell had shifts of accountants working from 4am in the morning until 11pm at night. With this activity all being run out of a suburban home it is unsurprising it led to official neighbour complaints made to the local council. Staff shared the desks but each had their own drawer in a desk belonging specifically to them. Ultimately staff numbers peaked at 59. Mr Russell stated he had no problem getting good staff as a lot of people found the flexibility of hours very suited to them, especially young mothers that had previously been full time accountants, who could work a couple of days a week at unusual hours suiting their other family responsibilities.

Mr Russell did have success in the 'doom and disaster business' as he referred to it. There were also the real disasters too, the real doom and gloom businesses that could not be rescued in any way.

### III THE TEMPLATE

*'...so anyway...they come across this Russell template...it was just a loss company taking over a profit company...now there is nothing wrong with that...and it is still done today...and they don't call it tax avoidance with anybody else...but with me they did...'*

John Russell, interview, Kawakawa Bay, 27 January 2010

The Taxation Review Authority (TRA) once estimated that up to 1,000 smaller businesses including 3,500 individuals had been affected by the Russell tax template.<sup>14</sup> This is hotly disputed by Mr Russell. The template was promoted and implemented firstly in 1980 with the last transaction entered into in 1986.

#### ***A The Russell Template discovered – the Pakuranga House Call***

Although Mr Russell has had numerous requests for information under s 17<sup>15</sup> *Tax Administration Act 1994* (NZ) (TAA) he has never been subject to a s 16<sup>16</sup> TAA request for information. When away on a business trip<sup>17</sup> Mr Russell spoke to his receptionist who said that there were 'a couple of guys sitting in a car...it looks like they are staking the place out.'<sup>18</sup> Mr Russell decided to head home early. When he arrived he saw a 'huge truck there with an army of people carrying files out of my house'.<sup>19</sup> His business affairs were under investigation by the Justice Department who were there with a Court order, as well as three policemen. Mr Russell thought perhaps 'they must have been expecting a big fight.'<sup>20</sup> Inland Revenue then issued a s 17 *Tax Administration Act 1994* (NZ) Notice

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<sup>14</sup> *Case T52* (1998) 18 NZTC 8,378, 121.

<sup>15</sup> Equivalent to s 264 of the *Income Tax Assessment Act 1936* (Cth).

<sup>16</sup> Section 16 TAA 1994 [Commissioner may access premises to obtain information]. This section is equivalent to s 263 of the *Income Tax Assessment Act 1936* (Cth).

<sup>17</sup> Mr Russell was approximately two hours out of Auckland. Mr Russell's practice when away was to phone daily to check in with the office.

<sup>18</sup> Interview with Mr John Russell, Kawakawa Bay, 27 January 2010.

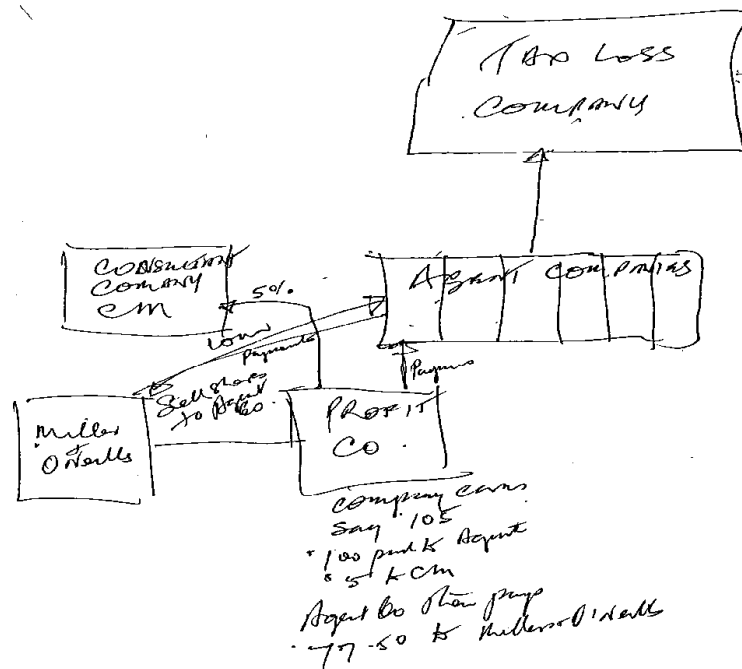
<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*

to Furnish Information to the Justice Department who soon after photocopied the files for Inland Revenue.<sup>21</sup> This led to the 'Russell template' being uncovered. Inland Revenue has never 'raided' Mr Russell's house although he suggested I should not talk too loud!<sup>22</sup>

### B The Template Explained

The template essentially is grouping a loss company with a profit company through various deeds and agreements. Originally the majority of the losses for the template came from the Manning Group of companies. Mr and Mrs Manning left for the United States in 1982, giving Mr Russell unfettered control over the losses, for which the Mannings were remunerated, much to the chagrin of Inland Revenue.



The 'Russell template', drawn by Mr J G Russell, 27 January 2010.

The usual application of the Russell template was the formation of shareholders in a trading or manufacturing company selling their shares in that company to Russell entities at an inflated price and the Russell entity paying for those shares using the profits earned by the company, less fees to Russell entities. Effectively, the profits of the trading or manufacturing company pass to loss owning Russell entities and, less Russell fees, are paid back to the shareholders as capital. The vendor shareholders continue to manage the business and usually have an option to buy it back after a time for a nominal sum when, sometimes, the whole process recommences.<sup>23</sup>

One would consider that taxpayers would be 'flocking' to utilise Mr Russell's tax schemes to turn the 'water' of taxable income into the 'wine' of untaxed gains. This was

<sup>21</sup> The photocopying of the files took approximately three weeks.

<sup>22</sup> Interview with Mr Russell, Kawakawa Bay, 27 January 2010.

<sup>23</sup> *Case T52 (1998) 18 NZTC 8,378 [6]*.

however, far from reality. In fact Mr Russell defends the template suggesting that not many people participated in it due to not wanting to relinquish ownership of their businesses. To utilise the template, a person had to be self employed, as it was not available to be used by a wage or salary worker. Mr Russell commented as follows:<sup>24</sup>

‘...[there was] no way could a wage earner use it...no way could a professional person use it...and it’s only those people who are prepared to sell their enterprise to someone else and then just work for it...and not own it...now there’s very few people that would do that...’

Mr Russell considered his tax arrangement as quite simple and validates it this way:<sup>25</sup>

It’s a tax loss company that has got losses buying an income stream...you could only do this type of transaction if you were a tax loss company...and therefore the arrangement didn’t generate the tax advantage...it was the fact that the company had tax losses that had generated the tax advantage...now there is nothing wrong with that and no one has ever suggested that there was...then it can’t be tax avoidance...because all the company did was buy an income stream to use up its tax losses.

Mr Russell further justifies the template by stating:<sup>26</sup>

My view is that it is not tax avoidance because the transaction itself doesn’t create avoidance, ...the avoidance if there is any is created by a loss company having the losses...so if they want to argue that those losses are not legitimate or something...that’s another issue, but the losses are legitimate...they have been suffered by real people...

There was reluctance on behalf of many approached with the template arrangement who did not wish to sell their business to the Russell group, although the arrangement allowed for the original owners to buy back the assets of the business at a future time if they wished, albeit at a non arm’s-length price. In fact, the Russell template could allow a business owner to re-enter the template mechanism again on similar terms to utilise a fresh set of losses. The lack of commerciality of the buyback was raised by Inland Revenue in various proceedings although Mr Russell never saw this as an important factor. The template transactions were not always a success either. In *Case M109* (1990) 12 NZTC 2,690 a motor car dealer requiring financial help cost the Russell Group parent company NZD \$2 million because of the financial guarantees given.

Mr Russell’s view of the template was that it was not a risk to the New Zealand tax base, as Inland Revenue would suggest, because in his opinion it was extremely rare for the circumstances to arise for someone to utilise the template. In *Case T52*<sup>27</sup> Judge Barber made a reference to a possible 1100 companies having the Russell template implant, (translating into affecting the lives of at least 2000, but probably about 3500 individuals). The Judge then stated only 76 groups had been placed on his Register.

### **C The Millers and O’Neils**

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<sup>24</sup> Interview with Mr J G Russell, Kawakawa Bay, 27 January 2010.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> *Case T52* (1998) 18 NZTC 8,378[121].

The most well known template case is that of *Miller & O'Neil*, having its ultimate conclusion in the Privy Council in 2001.<sup>28</sup> Mr Russell had been friends with the Miller and O'Neil families for several years prior to them entering into the template arrangement. In fact Mr Russell personally knew many of the people that became involved in the template. Mr Russell had previously been on the board of a company involved in the 'rag trade' whose shareholders were prone to frequent disagreement. Brent Miller was the accountant for the company who did his best to 'keep the peace.'<sup>29</sup> Mr Miller later formed Fiorucci Fashions Limited, one of the 'profit companies' to take part in the template scheme.

Mr Russell recalled:<sup>30</sup>

I liked Brent because he was a young guy, good thinker, knew what he was about, and had handled dealing with us...fighting shareholders, very well, I thought. So anyway, because of that association, he must have liked me too because he rang up one day and said "look, we have got a problem here".

Brent Miller and Brian O'Neil were aged in their 30s at the time of entering into the template scheme, being about 20 years younger than Mr Russell. Mr Russell recalls that Brian O'Neil was a real salesman and could 'sell anything...ice cream to Eskimos'<sup>31</sup>, and considered Brent Miller to have the personality and temperament to keep everything under control. Together, 'the two of them were great, wonderful'<sup>32</sup> recalls Mr Russell. Fiorucci Fashions Limited had around 25 employees and manufactured women's clothing for mall chain stores. Prior to the template transaction Brent Miller would contact Mr Russell for advice perhaps 2 or 3 times a year. When Fiorucci Fashions Limited struck liquidity problems Mr Russell offered to initially lend them money and ultimately Brent Miller and Brian O'Neil were offered the template arrangement. Mr Russell speaking of the template arrangement states:<sup>33</sup>

...the people were happy with the arrangement...probably because it returned more money for them than what they would get if they kept owning the assets themselves...so I suppose to that extent you could say that probably the tax advantage was one of the main reasons they did it...but it wasn't the reason the Millers and O'Neils did it...the Millers and O'Neils did what they did for the simple reason that they were facing going broke and this was a much better alternative...of being rescued immediately from their immediate problem and living to fight another day and if that day turned out well they would be all that much better off...

Brian O'Neil immigrated to the United States shortly after the Privy Council decision of *O'Neil v CIR* in 2001 where the Law Lords found the template to be 'blatant tax avoidance.' The Millers still live in Auckland.

#### IV INLAND REVENUE'S APPROACH – THE USE OF 'TRACKS'

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<sup>28</sup> *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC).

<sup>29</sup> Interview with Mr John Russell, Kawakawa Bay, 29 April 2010.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid.

Mr Russell's view is that the 'attack' by Inland Revenue on the Russell template transaction is simply part of a vendetta Inland Revenue has been running against him. He considers the way Inland Revenue assessed one taxpayer under 'Track A' then another under 'Track B' and so forth, and could change 'tracks', was all part of the vendetta campaign. Inland Revenue have pursued five different 'tracks' to tax various template participants, 'Track A' to the current 'Track E.'

### **A 'Track A'**

In the early stages of attempting to deal with the Russell tax schemes, the Commissioner of Inland Revenue (Commissioner) concentrated upon the tax saving afforded to the trading company by the disappearance of its profits in the form of administration fees. The Commissioner made assessments on the basis that the administration fees paid would not have been allowable deductions. 'Track A' sought to tax the profit company but by the time Inland Revenue was ready to pursue the money after successful litigation, the 'cupboard was bare', with the assets essentially being stripped out and only a shell remaining. Although there were quite a few 'Track A' cases, only two of them went to Court being Ron West Motors (Otahuhu) Limited (*Case M104* (1990) 12 NZTC 2,660) and K J Cummings Limited (*Case M109* 12 NZTC 2,690).

Mr Russell considered that 'if they were assessing the money they made a mistake in the first place choosing the company.'<sup>34</sup> He considered that, under s 99(3) *Income Tax Act 1976(NZ)*<sup>35</sup> where Inland Revenue must counteract a tax advantage derived from the arrangement, the only person capable of being assessed is the person who got the tax advantage. In his mind it was quite clear that the tax advantage in the Russell template was in the parent company.

### **B 'Track B'**

The Commissioner then turned his attention to what their Lordships in the later Privy Council judgment of *O'Neil v CIR* (2001) 20 NZTC 17,051 (PC) regarded as the essence of the scheme, and assessed the appellant taxpayers on the footing that they would have received the company's net profits as remuneration. The 'Track B' assessments pursued the original shareholders, such as the Millers and O'Neils. Again this was successful to some extent. For example, Brent Miller settled with Inland Revenue, Brian O'Neil headed overseas without fully paying the tax debt. At issue in *Miller v CIR; Managed Fashions v CIR* (1998) 18 NZTC 13,961 was whether this changed approach was an appropriate application of the reconstruction power in what is now s GA 1 ITA 2007 (then s 99(3) ITA 1976). It was held that the application was appropriate. The matter

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<sup>34</sup> Ibid.

<sup>35</sup> Section 99(3) *Income Tax Act 1976* (NZ) [Adjustment of income] gives the Commissioner a wide reconstructive power. Under s 99(3) the Commissioner 'may' have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, but he is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question (at NZTC 13,980, NZLR pp 301 to 302). On appeal to the Privy Council in *O'Neil v CIR* (2001) 20 NZTC 17,051 the taxpayer's argument was dismissed, the court saying at [31]: "...provided that he was not using inconsistent hypotheses for his reconstructions, he was in their Lordships' opinion entitled to assess any party who had obtained a tax advantage."

was appealed to the Privy Council in *O'Neil v CIR* (2001) 20 NZTC 17,051 where the taxpayer's argument was dismissed.

### **C 'Tracks C & D'**

The least understood assessment 'tracks' and perhaps the most difficult to follow were the 'Track C' assessments. In September 1996 the Commissioner embarked on a new assessment process originally called 'Track C'. The basis of the 'Track C' assessments was that the Commissioner could assess the parent companies because 'the whole thing was a sham.'<sup>36</sup> The assessments based on the doctrine of sham were ultimately withdrawn by Inland Revenue although the time it took to do so appears to be quite excessive. Mr Russell stated 'we were never able to work out what "Track C" truly did...because we were never allowed to cross examine the architect of it.'<sup>37</sup> He considered that this particular argument 'didn't have feathers to fly with in the first place'<sup>38</sup> and it never got tested because 'Track C' was ultimately withdrawn. There were about one hundred 'Track C' assessments actually issued by the Commissioner; however, none of these assessments were paid.

Mr Russell stated that the 'Track C' process was 'unintelligible and neither the Commissioner's officers who were giving evidence or the taxpayers fully understood what was happening'. In fact, even now, Mr Russell said that he does not know for sure what the 'Track C' assessment process was all about. Interestingly, *Case U23* (1998) 18 NZTC 8,378 demonstrates the confusion that existed around this particular 'Track'. Barber J (at paragraph 18) states:

It seems to me that there has been confusion over this so called Track C assessment approach to date because, when referring to it, witnesses and/or counsel have not necessarily been talking about the same thing. It seemed to me that even different witnesses for the respondent (Inland Revenue) had a different definition of Track C.

Simply put, there were two tracks, 'Track C' taxing the parent company, and 'Track 'D' taxing Mr Russell with regard to the 5 percent consulting fee ascribed to Commercial Management (sold to Commercial Management Partnership in 1994).

### **D 'Track E'**

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<sup>36</sup> In *Snook v London West Riding Investments Limited* [1967] 2 QB 786, 802 where Diplock LJ said that 'sham' '...means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities...that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating.'

<sup>37</sup> Interview with Mr John Russell, Kawakawa Bay, 29 April 2010.

<sup>38</sup> *Ibid.*



'Track E', which has been the subject of more recent litigation, attempts to tax all income derived by the Commercial Management Partnerships to Mr Russell personally.<sup>39</sup> The amount at stake under 'Track E' as at April 2010, was NZD \$138,796,819.38. This amount has been increasing daily due to use of money interest and late payment penalties.

In the Auckland High Court in 2010<sup>40</sup> Mr Russell challenged the 'Track E' assessments claiming that he had 'never received any benefit from the money.' Wylie J, in a succinct decision, dealt with this aspect of Mr Russell's case saying that the definition of tax avoidance was broad enough to capture his activity. He was the 'main man' in charge of everything and had the ultimate control of the funds.

For the first time Mr Russell (via counsel) accepted that there were 'arrangements' for the purposes of section 99 ITA 1976 and its successor between the Commercial Management partners and the various loss companies over the period. Mr Russell conceded that while tax avoidance had occurred, it was restricted to the loss companies and the taxpayer. Inland Revenue took a broader analysis. Mr Russell has sought appeal of this finding to the Court of Appeal who will hear the case in February 2012.

Mr Russell has no doubt that if he is successful in the 'Track E' litigation then 'Track F' would soon be on the Inland Revenue 'drawing board'. The 'Track E' assessment process is considered by Mr Russell to be plainly designed to cover deficiencies in 'Track D'. In the 'Track E' assessments the Commissioner is assessing not only the 5 percent consulting fee and add-ons, but also the whole of the income declared by the Commercial Management business partnerships over some 15 years, to Mr Russell personally. Mr Russell was unable to personally attend the 'Track E' High Court case due to requiring back surgery at the time.

Mr Russell did not contest that the arrangement by which the six Commercial Management partner companies (see diagram of the template above – the 'agent companies') diverted their income to loss companies amounted to tax avoidance and that it was void as against the Commissioner. He did contest that his personal relationship with the companies as director was part of the tax avoidance arrangement. It was submitted that no tax was avoided as a result of the director/company relationship and that Mr Russell was not a party to *or affected by* the tax avoidance arrangements. It was also argued that each company was a separate legal entity<sup>41</sup> and that there was no legal basis for lifting the corporate veil to assess income to Mr Russell as a director simply because he was a director.

When considering the scope of the arrangement with respect to Mr Russell, Wylie J stated that:<sup>42</sup>

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<sup>39</sup> Mr Russell considers this 'daft' due to the fact that he employed up to 59 people doing the work. In Court, Mr Russell's business structure was compared to that of a partner of an accounting firm and quickly dispensed with by His Honour.

<sup>40</sup> *Russell v CIR* (2010) 24 NZTC 24,463.

<sup>41</sup> See *Salomon v Salomon* [1897] AC 22 and *Lee v Lees Air Farming Limited* [1961] AC 12.

<sup>42</sup> *Russell v CIR* (2010) 24 NZTC 24,463 [96(f)].

he personally promoted the Russell template; he could be contacted personally by clients; he supervised all staff employed by CML [Commercial Management Limited]; he signed all cheques; he signed all agreements on behalf of the partners; he was the receiver, liquidator or director of all loss companies; he corresponded on behalf of the partnership with the loss companies; he introduced new loss companies when needed.

In summary, Wylie J considered there was one overall arrangement over the years 1985 to 2000 (inclusive). His judgment stated:<sup>43</sup>

In my judgment, there was one overall arrangement over the years 1985 to 2000 (inclusive). It was put in place by Mr Russell. It comprised a convoluted series of interlocking contracts, agreements, understandings and plans. They are collectively evidenced and constituted the arrangement. There were changes to entities involved in the arrangement over the years. The partners in the Commercial Management Partnership changed. There were changes to the loss companies over the years. Indeed changes to the loss companies were inevitable. It was inherent in the model that new loss companies would be required from time to time as losses in the old loss companies were exhausted. The fact that new entities were, from time to time, introduced to maintain the structure does not preclude there being one overall arrangement. Regardless of the entities, the end result was that income was diverted into companies that had losses and those losses were utilised to avoid the payment of income tax on the income. The basic arrangement remained essentially unchanged for 15 years. This points to there being one overall arrangement.

Mr Russell's involvement in all that occurred was in Wylie J's view the most relevant factor in concluding there was one overall arrangement. His Honour considered Mr Russell as the 'lynchpin on which all turned', paraphrasing a description used by Lord Denning MR in *Wallersteiner v Moir*:<sup>44</sup>

'[Mr Russell] controlled [the parties'] every movement. Each danced to his bidding. He pulled the strings. No one else got within reach of him. Transformed into legal language, they were his agents to do as he commanded. He was the principal behind them.'

Wylie J considered it beyond dispute that Mr Russell controlled everything and that he was the architect of the overall plan. Each of the parties to the arrangement, starting with Mr Russell and finishing with Mr Russell, had the expectation that the other parties would act in a particular way, because all of their actions were orchestrated by Mr Russell. In effect, Mr Russell provided consensus, although Wylie J doubted that this was a necessary ingredient of any arrangement.<sup>45</sup>

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<sup>43</sup> Ibid [99].

<sup>44</sup> *Wallersteiner v Moir* [1974] 1 WLR 991.

<sup>45</sup> An arrangement is defined to include a 'plan'. The use of the word 'plan' in contradistinction with the words 'contract and agreement', suggests that consensus is not a necessary ingredient. A plan can be devised and carried out by one person, as was the case with Mr Russell and the template. In *BNZ Investments Limited v C of IR* (2000) 19 NZTC 15,732, at 15,787 the court held that a contract, plan or understanding required conscious involvement and that s BG 1 was confined to persons engaging in consensual activity towards an end (at 15,789). The majority in the Court of Appeal decision of *C of IR v BNZ Investments Limited* (2001) affirmed the High Court decision. The majority in the Privy Council decision *Peterson v C of IR* (2005) 22 NZTC 19,098 held that a taxpayer does not need to be a party to an arrangement to be affected by it, while knowledge of the arrangement's details is also unnecessary.

The arrangement was not confined to the agreements between the partners and the loss companies as proposed by Mr Russell. Wylie J said this because the partners and the loss companies derived no benefit from the arrangement and took no independent role in the overall plan. They were functionaries that acted at Mr Russell's behest. The end result of the arrangement was Mr Russell deciding how untaxed monies he directed into the finance companies were to be utilised.<sup>46</sup>

Mr Russell claimed that he used legitimate corporate and trust structures. The recent *Commissioner of Inland Revenue v Penny* (2010) 24 NZTC 24,287 (CA) and *Penny v Commissioner of Inland Revenue* [2011] NZSC 95 judgments make it clear that this is not the end of the matter. The Commissioner was not challenging the legitimacy of the structures put in place by Mr Russell but was challenging the way those structures were applied.

Wylie J had reached the view that the arrangement put in place by Mr Russell was designed to ensure that income which Mr Russell earned through his personal exertions was diverted into a series of partnerships and companies controlled by him, and that no tax was paid on that income, with Mr Russell retaining control and directing how the untaxed monies were used. Wylie J accepted that Mr Russell may have preferred to trade through a corporate structure<sup>47</sup> to avoid any personal liability; however that was not the end of the matter. His Honour considered the arrangement as 'so tortuous that it is hard to escape the conclusion that it was put in place simply to obfuscate the situation and to confuse even the most diligent tax inspector.'<sup>48</sup>

With respect to Mr Russell and his numerous staff, Wylie J considered the evidence was clear that Mr Russell supervised all of the activities of the various employees. He reviewed all of their work and signed all correspondence including cheques. In his view, the fact that some or even much of the work was undertaken by employees did not materially affect the relationship between Mr Russell's personal exertions and the earning of the income of Commercial Management Limited.

Referring to the *Commissioner of Inland Revenue v Penny* (2010) 24 NZTC 24,287 (CA) decision, Wylie J addressed the issue of Mr Russell's salary. Mr Russell allocated a nominal salary to himself each year that did not bear any relationship to the work Mr Russell undertook or to salaries properly payable in the marketplace. Very significantly, Mr Russell retained control of the whole of the income generated with only he being able to direct how it was to be applied. In Wylie J's view the income of the Commercial Management partnership was derived from Mr Russell's personal exertions and he had retained complete control over it.

Wylie J agreed with Judge Barber in the TRA that the steps taken by Mr Russell were not within the purpose or contemplation of Parliament<sup>49</sup> when it enacted the loss offset

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<sup>46</sup> *Russell v Commissioner of Inland Revenue* (2010) 24 NZTC 24,463 [102].

<sup>47</sup> *Salomon v Salomon* [1897] AC 22(HL).

<sup>48</sup> *Russell v Commissioner of Inland Revenue* (2010) 24 NZTC 24,463 [118].

<sup>49</sup> The Supreme Court decision in *Ben Nevis Forestry Venture Limited v Commissioner of Inland Revenue* [2008] NZSC 115 now constitutes the definitive statement on the law of income tax avoidance in New Zealand. The taxpayer must satisfy the court that the component parts of the arrangement fall within the specific taxing provision, construed in light of its purpose, and are within Parliament's

provisions contained in s 191 ITA 1976 and its successor sections. His Honour considered that the unrestricted transfer of profits to loss companies included in the group, purely because of the losses they brought with them, in the manner the template sought to achieve, would bypass the company grouping rules contained in the legislation, and significantly undermine the tax base contrary to Parliament's intention.

Further, in Wylie J's view, the steps taken by Mr Russell to divert the income which he generated by his personal exertions into the Commercial Management partnership were not within the contemplation of Parliament. Parliament had intended that individuals pay income tax at the appropriate rate on their net income. Wylie J referred to an obiter statement from *Spratt v Commissioner of Inland Revenue*<sup>50</sup> that:

'no taxpayer can, by way of assignment, escape assessment of tax on income resulting from his or her personal activity, and that such income always remains truly as income and is derived by him irrespective of the method he may adopt to dispose of it.'

In conclusion, Wylie J considered that Mr Russell had structured the arrangement so that he gained a tax advantage in an artificial and contrived way. In his Honour's view, the purpose of the complex corporate structure was to divert income from Mr Russell's personal exertions, whether generated either directly through Mr Russell's activities, or indirectly through his control of employees, into companies, who were able to access the losses in the unrelated companies to avoid the payment of income tax. At no stage did Mr Russell lose control of the monies. They could only be applied as he directed. The companies and other entities used were all ultimately controlled by Mr Russell. At no point was the income beyond his direct control. Ultimately Mr Russell, and other entities which he was interested in or controlled, benefited from advances made by the finance companies controlled by him.

Wylie J stated that the arrangement subject to this appeal not only had the effect of altering the incidence of income tax, but that this was also its primary purpose. By virtue of s 99(3) ITA 1976 the Commissioner could adjust the assessable income of any person affected by the arrangement so as to counteract any tax advantage obtained. Once the existence and scope of the tax avoidance arrangement had been established, all those taxpayers who have benefited from it are subject to corrective adjustment by the Commissioner in the exercise of the reconstruction powers conferred by the anti-avoidance provisions.

Mr Russell's counsel submitted that Mr Russell was not a person affected by the arrangement. He argued that Mr Russell did not receive a dollar from the arrangement, either directly or indirectly. Wylie J, with respect, stated that this was not the test. The correct test was whether Mr Russell was a person affected by the arrangement through obtaining a 'tax advantage' from it.<sup>51</sup> Nonetheless, Wylie J accepted that Mr Russell did

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contemplation; and that the arrangement as a whole is within Parliament's contemplation. At [108] of the judgment the Supreme Court observed that '...a classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.'

<sup>50</sup> [1964] NZLR 272 (HC) at p 274.

<sup>51</sup> *Russell v Commissioner of Inland Revenue* (2010) 24 NZTC 24,463 [142].

not directly receive any of the income generated by the arrangement, but that was because the *purpose* of the arrangement was to ensure that he did not have to pay tax on that income.

Wylie J agreed with the TRA that the income was Mr Russell's personal exertion income. His Honour also agreed with the TRA that Mr Russell was the only real person underpinning the arrangement. Mr Russell was the person who 'pulled all the strings'.<sup>52</sup> Mr Russell controlled all of the untaxed monies through the finance companies and no one else could access the funds unless he permitted them to do so. Money was advanced by the finance companies to Mr Russell to enable him to meet his personal obligations. Monies were also advanced to various trusts which Mr Russell had settled for the benefit of his family.

## V RECUSAL

The 'Track E' litigation also led to an application for judicial recusal.<sup>53</sup> The issue of bias had never been raised in any template cases prior to Mr Russell's personal assessment under 'Track E'. Mr Russell considered it fatal to have his personal case, 'Track E' heard at first instance before the same judge who had heard the template litigation for over some twenty years. Judge Barber would have previously had several hundred hearing days concerning the template litigation, with Mr Russell considering that Judge Barber's bias and preordained views had become quite apparent. Perhaps the most notable comment was raised in *Case R25* where Judge Barber had stated his view that Mr Russell was a tax avoidance specialist, with an 'obsession with saving tax', that the taxpayer had a 'mental block' affecting his judgment;<sup>54</sup> and that the taxpayer had used due process for the purposes of delay and confusion. Mr Russell requested that Judge Barber recuse himself from the 'Track E' litigation; however, Judge Barber refused, with Mr Russell seeking an appeal on the recusal grounds through a higher court. In both the High Court<sup>55</sup> and Court of Appeal<sup>56</sup> the recusal application was dispensed with. The Court of Appeal at [3] acknowledged that there was a basis for Mr Russell's objection to Judge Barber hearing the case but did not need to decide whether he should have recused himself because of the view that any basis for challenge had been overtaken by the High Court rehearing the merits of the challenge to the tax assessment. There was no question of the High Court decision of Wylie J being tainted by bias because no such allegation was made against the judge and the facts applied were established by agreement. The question of whether the Taxation Review Authority should have recused himself was accordingly treated by the Court of Appeal as moot. Mr Russell, representing himself, unsuccessfully sought leave to appeal to the Supreme Court.<sup>57</sup>

## VI THE VENDETTA CLAIM

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<sup>52</sup> Ibid [143].

<sup>53</sup> The recusal of TRA Authority Barber J who has heard numerous template cases. Mr Russell considers bias a real prospect in his own tax case.

<sup>54</sup> *TRA 92/061, 92/062, 92/063, 92/064, 92/065* at 33. Alt cit. *Case R25* [1994] 16 NZTC 6,120.

<sup>55</sup> *Russell v Taxation Review Authority* (2009) 24 NZTC 23,284.

<sup>56</sup> *Russell v Taxation Review Authority* [2011] NZCA 158.

<sup>57</sup> *JG Russell v Taxation Review Authority and Commissioner of Inland Revenue* SC 56/2011, [2011] NZSC 96.



### ***A Information Requests Directed to Mr Russell***

Mr Russell may have received more section 17 TAA<sup>58</sup> information requests than any other tax agent or individual taxpayer. During an interview, Russell stated that he had received thousands of section 17 TAA requests for information over the years. He views this as having nothing to do with information collection but is part of 'plain pure vendetta harassment'<sup>59</sup> further stating 'because it is a vendetta...it's an absolute war that goes on...they dream up any way they can waste my time...'<sup>60</sup>

Mr Russell was prosecuted for 226 'failure to furnish' information charges and considered this too to be part of the vendetta.<sup>61</sup> At the height of the information seeking by Inland Revenue he was receiving an average of 3,500 information requests per year for about three years. The requests were so frequent that Mrs Russell kept a record book of how many would turn up each day. October 1, 1996 was the day that held the record – 101 requests arriving in courier bags.<sup>62</sup>

### ***B The Vendetta Claim in the Taxation Review Authority***

There are two cases in relation to the claim of vendetta that Mr Russell regards as significant. Mr Russell stated:<sup>63</sup>

'...Judge Willy used to give me quite a tongue lashing about this vendetta business...but he had never seen the evidence of it until *Case U11*.'

#### ***1 Case U11***

*Case U11* (1999) 19 NZTC 9,100 was not a template case. In fact, Mr Russell's role was purely on a professional basis, being instructed to act by his client, Dandelion Investments Limited. It was alleged the taxpayer was prejudiced because of the antagonistic attitude shown towards Mr Russell by Inland Revenue officers. These included such matters as withholding information that was essential to the proper preparation by the tax agent of a case, and managing a trial by ensuring the wrong witnesses were called by the Commissioner. The TRA found that these complaints were made out. Judge Willy was satisfied that in relation to these complaints the taxpayer was not treated even-handedly. In some respects the Commissioner adopted what the TRA described as a 'thoroughly unmeritorious stance'.<sup>64</sup> Judge Willy held it was quite

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<sup>58</sup> Section 17 TAA 1994 Information to be furnished on request of Commissioner.

<sup>59</sup> Interview with Mr John Russell, Kawakawa Bay, 27 January 2010.

<sup>60</sup> Ibid.

<sup>61</sup> Mr Russell was not convicted. He was 'dead lucky' (interview 27 January 2010) as he was able to prove that the person that issued the informations (charges laid in the court) was not authorised to do so. Mr Russell estimated this case cost Inland Revenue and him in the vicinity of \$1 million dollars combined. The only reason he won was due to a procedural mistake. Mr Russell became aware of the authorisation issue during cross examination of Denise Latimer, who was on the Russell Team. Mr Russell stated that he holds a deep respect for Denise Latimer.

<sup>62</sup> On the day of our interview on 30 April 2010 Mr Russell showed me five s 17 notices that had arrived that morning. He estimated that they would take a couple of days to comply with, but stated it is now so much easier to comply with the volume of requests than it used to be.

<sup>63</sup> Interview with Mr John Russell, Kawakawa Bay, 29 April 2010.

<sup>64</sup> *Case U11* (1999) 19 NZTC 9,100, 9,137.



wrong for the Commissioner's staff to allow their feelings for Mr Russell personally (whether or not they were well founded) to rebound to the detriment of the taxpayer<sup>65</sup> He found the allegations of lack of impartiality and unnecessary obstruction of the taxpayer by the Commissioner to be proved.

The second allegation of managing the trial by ensuring the wrong witnesses were called was considered by Judge Willy to be very serious and 'if made idly would deserve censure.'<sup>66</sup> In essence the complaint was that the Commissioner had deliberately chosen an employee to give evidence on behalf of the Commissioner whose knowledge was so limited that the objector (Dandelion Investments Limited) was precluded from exercising its rights of cross examination in any useful way, in essence stonewalling Dandelion's attempts to prove that the assessment was wrong and by how much.

Judge Willy had some sympathy for the Inland Revenue witness who was subjected to days of gruelling examination on matters of which he had very little firsthand knowledge.<sup>67</sup> Much of his evidence amounted to no more than his views on the work and the opinions of others.<sup>68</sup> He considered that the witness should never have been asked to bear the weight of the Commissioner's case and the question was why was he put in that position when there were others much better qualified.

Judge Willy saw only two possibilities - either the witness was called by mistake or the choice of a patently inappropriate witness was by design. In the absence of evidence from the Commissioner on this point the Judge was left to draw his own inferences. He could not accept that somebody as experienced in tax litigation as the Commissioner with all the legal resources would have made such an elementary mistake. Judge Willy concluded that the decision to rely on an inappropriate witness was consciously made. The effect seriously undermined the ability of the taxpayer objector to prove that a tax assessment was wrong and by how much. The decision of the inappropriate witness also added unnecessarily to the hearing, and the time taken to write the judgment. The Judge considered it resulted in a serious misuse of the resources of the TRA. More importantly, Judge Willy stated that it meant that the taxpayer objector was put into an unhappy position of itself calling the appropriate departmental witnesses at its own cost in order to seek to discharge the onus of proof resting on it. It also significantly lengthened the case and fuelled Mr Russell's concerns that the taxpayer, for whom he appeared, had not been treated by the Commissioner in an even-handed way.

Judge Willy considered this attitude at odds with the way Mr Russell presents to the TRA and stated 'He puts forward, and argues his cases professionally albeit trenchantly.'<sup>69</sup> The Judge strongly stated that 'It is for the Courts to decide the merits of the cases that arise, not for the Commissioner to seek to obstruct the objector's ability to have those merits put before the Court.'<sup>70</sup> Judge Willy considered this a matter of serious public interest and saw it as the resources of the Court and monies of clients

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<sup>65</sup> Ibid 9,139.

<sup>66</sup> Ibid 9,137.

<sup>67</sup> Ibid 9,138.

<sup>68</sup> Ibid 9,139.

<sup>69</sup> TRA No. 93/103, Alt cit. *Case U11*, at 51.

<sup>70</sup> TRA No. 93/103, Alt cit. *Case U11*, at 52.

being dissipated in adjudicating on sterile side issues which should never, (or perhaps rarely), be allowed to arise. Judge Willy also referred to cases involving this taxpayer objector as well as the *Miller* and *McDougall* cases,<sup>71</sup> as illustrating the fact that this sort of wrangling in any case Mr Russell was involved in was becoming the norm.

Judge Willy stated, 'this feuding must stop. The Department must treat Mr Russell's clients as impartially as they treat those of any other tax practitioner.'<sup>72</sup> The Judge found the allegations of lack of impartiality, and unnecessary obstruction of the objector taxpayer by the Commissioner to be proved.

Judge Willy also held that this finding vitiated the assessment. On appeal<sup>73</sup> before Tompkins J, his Honour was not disposed to disturb that factual finding. However, the finding by the TRA that the lack of impartiality and unnecessary obstruction of the objector by the Commissioner vitiated the assessment did not stand.

## 2 Case U16

The other case considered by Mr Russell as evidence of him being treated unfairly is *Case U16* (1999) 19 NZTC 9,168. The case involving Inland Revenue Special Audit concerned the deductibility of various expenses of a business conducting motor vehicle auctions. A creditor had put the taxpayer into liquidation and Mr Russell was appointed as receiver. From extensive evidence Judge Barber concluded that, at all material times, the financial records of the objector company were quite inadequate and in rather a mess. That situation developed well before Mr Russell was able to take control of the taxpayer's affairs, and he had done his best to reconstruct matters but, naturally, in a favourable manner to the objector. With regard to Inland Revenue's conduct Judge Barber stated:<sup>74</sup>

At this point I record that Mr Russell made extensive submissions along the lines of improper purposes and motives of officers of the respondent and alleged a general *venda-tta* (sic) of the respondent's department towards him and his clients. I noted, in the course of the hearing, that I felt that the attitude of the respondent's department to Mr Russell "lacks maturity and needs polishing". I have often felt that officers of the IRD are quite unhelpful to Mr Russell - *sometimes hostile to him and sometimes flippant*. Such attitudes do not assist resolution of tax disputes whether between the department and Mr Russell or his many clients. I appreciate that Mr Russell's interpretation of revenue laws, particularly, in terms of tax avoidance, and his general strategies and the extent of his tax advisory business, are *thorns in the side of the department* and relate to enormous unpaid taxes overall; but *treating him as an enemy of the State* does not expedite resolution. However, in this case those IRD attitudes do not affect the validity or integrity of the assessment process. **(My emphasis)**

## VII INLAND REVENUE PERCEPTIONS OF MR RUSSELL

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<sup>71</sup> Mr Russell had made a similar allegation in *Miller v CIR; Managed Fashions Limited v CIR* (1998) 18 NZTC 13,961.

<sup>72</sup> TRA No. 93/103, Alt cit. *Case U11*, at 52.

<sup>73</sup> *Commissioner of Inland Revenue v Dandelion Investments Limited* (2001) 20 NZTC 17,293.

<sup>74</sup> *Case U16* (1999) 19 NZTC 9,168, 9,169.

*'He was always pleasant to deal with and doesn't harbour a grudge'*

Ian Ramsay, Justice Department

### **A Introduction**

It would be difficult to imagine an individual taxpayer that has had more interaction with Inland Revenue of a sustained nature than John George Russell. By early 1992 the Russell template and template cases had become a serious concern for Inland Revenue, mainly that other tax agents may copy the template if they saw Mr Russell 'getting away with it'.<sup>75</sup> Crown Law was approached for help to develop a strategy to address the concerns raised by Mr Russell's activities, which were having a significant effect on Inland Revenue resources.<sup>76</sup>

Inland Revenue considered that because of Mr Russell's success in concealing information and Inland Revenue's lack of coordination and commitment in dealing with him, it was difficult to form an overview of his activities and his use of Inland Revenue's resources. A clear limitation with this paper is the lack of being able to interview Inland Revenue with regard to Mr Russell, however the 1992 Oomen Report and the 1994 Booth Report provide some insight into the concerns Inland Revenue held in respect of Mr Russell and his tax activities.

### **B Overview & Oomen Report**

The Oomen Report was written to identify and address the concerns being raised by Mr Russell's activities. Mr Michael Oomen,<sup>77</sup> referred to Mr Russell's motivation as being a mystery. He considered that Mr Russell's motivation may have been:

'...a sense of satisfaction at having successfully accumulated wealth, and having outwitted and out manoeuvred the Justice Department, the Inland Revenue Department, the Courts and creditors over 15 years'.<sup>78</sup>

Oomen described Mr Russell as 'being in this tax avoidance *game* now for almost 15 years' and that 'money does not seem to be a major concern of his, unless he has pulled off the most extraordinary deception for the last decade and a half.'<sup>79</sup> Mr Russell has always appeared to have a modest lifestyle. The Oomen Report continued: 'it is unlikely that Mr Russell is deceiving people over his lack of interest in money. No-one I have

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<sup>75</sup> Oomen Report, (1992) [1.6]. The Report was headed 'Draft Strategy for Dealing with J G Russell' and was dated late 1992.

<sup>76</sup> Although impossible to gauge the amount of tax avoided for Mr Russell's clients it was estimated to be in the vicinity of between \$20 million over six years to in excess of \$40 million over eight to ten years (Oomen Report, paragraph 1.4).

<sup>77</sup> Mr Michael P J Oomen was a regional solicitor, Northern Region, Inland Revenue. The Report was headed 'Draft Strategy for Dealing with J G Russell' and was dated late 1992.

<sup>78</sup> Oomen Report, 'Biography of J G Russell', Appendix 'A', [16].

<sup>79</sup> Ibid.

spoken to can see him ceasing his activities and leaving the country to live a life of luxury in some tax haven'.<sup>80</sup>

Oomen wrote that those that had dealt with Mr Russell over a long period believed that it had all become a 'game' to him. Oomen thought that if that were so, Mr Russell had become someone who was 'possessed' by it. By way of example Oomen referred to the voluminous correspondence involving over 20 detailed *Official Information Act 1982* (NZ) (OIA 1982) requests in respect of a tax matter where the tax at issue was in the order of \$20.00!<sup>81</sup>

It would appear that in 2011 the 'game' is now wearing a bit thin with Mr Russell stating 'I'm getting sick of it for the simple reason that I'm getting old, everything's taken longer to do, and you think there's better things to do than this.'<sup>82</sup>

It was estimated by the Northern Region of Inland Revenue that Mr Russell was successfully tying up in excess of 18,000 employee hours (more than nine full time staff) each year, for every year.<sup>83</sup> A 'primary weapon in Russell's armoury' was continual delay. A typical Russell tactic, according to Oomen, was to withhold or deliberately supply incorrect information. Mr Russell had conducted a 'correspondence war' on behalf of his clients, and had 'abused' rights provided for under the OIA 1982. Oomen considered requests for information under the OIA 1982 were for information of 'no value and an undisguised attempt to tie up administrative resources'.<sup>84</sup> Over a one month period<sup>85</sup> an Inland Revenue employee (Mr Player, the chief 'architect' of 'Track A') received 29 letters from Mr Russell seeking information. One request dated 29 January 1992 contained 31 specific requests pursuant to the OIA 1982. A typical letter would make 15 to 16 requests for information. Mr Oomen had personally answered a single Russell letter containing 7 requests for information and it took him five hours to complete! One of the most time consuming tasks was answering the OIA 1982 requests coming to Inland Revenue.

Three or four OIA 1982 requests were coming in for each client (company and shareholders) after amended assessments had been issued addressing the tax avoidance. If any of the OIA 1982 requests had gone unanswered Mr Russell would apply for a court adjournment citing the non-response to his letters. In a similar vein, if these tactics were not working as efficiently as expected, Oomen stated that another technique used by Mr Russell was to send letters and requests to entirely different sections of Inland Revenue so that one section of Inland Revenue would not know that another section had received a request. Often the first a particular Inland Revenue section would know about a request received by another section would be when Mr Russell raised the particular letters in court. A claimed variation to this theme was for Mr Russell to start dealing with one Inland Revenue section, then to start corresponding with another section of Inland Revenue without telling either that he was dealing with the other! If any contrary decisions from different Inland Revenue District Offices were

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<sup>80</sup> Ibid.

<sup>81</sup> Ibid [17].

<sup>82</sup> 'Russell continues 30 year tax battle', *The Press*, 29 April 2011.

<sup>83</sup> Oomen Report, (1992) [1.5].

<sup>84</sup> Ibid [3.7.1]

<sup>85</sup> The one month period was from the start of January 1992 to early February 1992.

received on the same issue, he would use this as ammunition to attack the other decision.

According to Oomen, Mr Russell would also request a review of any decision made by Inland Revenue. Harassment of individual tax officers was also a claim made by Oomen. It was claimed that Mr Russell demanded to know the names of those dealing with a file, as well as their proof of authority. Oomen stated that if Mr Russell was unhappy with the outcome of a case, he would threaten the officer concerned with the prospect of a formal complaint about their performance, or sometimes threaten to personally sue them. It was claimed this tactic was often effective at the Inland Revenue District Office level by inculcating fear, with a resulting inaction on the part of the person to whom the request was addressed. Oomen suggested that the delay suited Mr Russell, who generally would only act again if Inland Revenue sought to take some recovery or compliance action. When action was commenced, Mr Russell would lodge a formal complaint with the regional controller over a *lack of response* by the departmental officer concerned.

Oomen also stated a Russell ploy was to create 'a bewildering network of companies and partnerships.'<sup>86</sup> In many cases, according to Oomen, companies that formed part of Mr Russell's tax schemes were included for no apparent reason other than to complicate and confuse investigators.

### ***C The Booth Report & the Russell Team***

Mr Russell is one of a few people who have had a dedicated team of investigators and legal counsel solely focused on his activities. This team was known as the 'Russell Team'. The Oomen and Booth Reports were both written in early 1990s addressing the concerns Inland Revenue had over Mr Russell's template scheme and the impact it would have on a larger tax population.

The Booth Report<sup>87</sup> followed on from the Oomen Report. It covered the formation and activity of the Russell Project Team. Reg Booth was the project Manager and was well aware of the issues surrounding Mr Russell and his interaction with Inland Revenue. The report set out an outline of the enforcement strategy towards Mr Russell. The information requests from Mr Russell had not abated and in 1994 Booth commented:

'each succeeding request (and our reply) gets longer and longer and the content deteriorates as well. In fact, in talks with the Ombudsman's Office they have indicated that after second requests the requests are really debates on the various points he wishes to raise'.

One Inland Revenue staff member had at the time of the Booth Report answered 350 letters!<sup>88</sup> Booth commented that the letters were wide ranging and sought information

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<sup>86</sup> Oomen Report [3.12.1].

<sup>87</sup> The Booth Report was dated 11 February 1994 and had a picture of a boat oar on the front of it. The letters on the oar appeared as 'O. A. R.' Mr Russell questioned the significance of the oar and the letters. He suggested to Mr Booth that they stood for 'Operation against Russell'. This was neither confirmed nor denied.

<sup>88</sup> Booth Report, [5.11].

on personnel, the Commissioner's practice, copies of internal documents, the reasons for everything, as well as the basic facts that most others would limit their request to. There was a close similarity in all the requests, but there was enough variation to prevent Inland Revenue from answering 'refer to reply of another request.'

Benefits in establishing the 'Russell Team', were seen as rapidly developing expertise in dealing with Mr Russell, preventing Mr Russell's ability to effect delay by directing matters to people with little or no experience, reducing the effect of his harassment technique, and allowing Inland Revenue to build an accurate picture of his activities, and to be consistent in their dealings with him. The team commenced in July 1993 with Mr Reg Booth the initial project manager. Booth considered Mr Russell's activities the 'biggest tax avoidance scam in New Zealand.'<sup>89</sup> He suggested that if Inland Revenue took firm action the Russell scheme would be dealt a 'mortal blow', and that 'we shall win the approbation of many other taxpayers and we shall present our masters with a handsome dollar return.'<sup>90</sup> Booth, perhaps rather optimistically in hindsight, thought that 'the firstfruits (sic) of such a vision can be gathered in before 30 June 1994'.<sup>91</sup>

The Booth Report clearly stated that Inland Revenue:

'must increase investigations of him over all revenues, we must maintain any pressure he feels and if necessary increase it where appropriate...and in court work be more aggressive against him, i.e. take the fight to him.'<sup>92</sup>

An enforcement strategy was prepared and was concentrated on answering correspondence, to preparing for upcoming court cases, and to 'home in on Russell and "his" companies.'<sup>93</sup> Booth stressed the absolute necessity of a coordinated approach... '...to hit him personally....but not put him out of business, although that may be a natural end result'.

## **VIII THE COMPLIANCE MODEL AND MR RUSSELL**

The Inland Revenue Compliance Model<sup>94</sup> focuses on the strategies adopted by those enforcing the law. Different strategic responses can be adopted by those on the receiving end of the law too, and these translate into different approaches to compliance.<sup>95</sup> Motivational postures reflect the degree to which individuals are accepting of a tax authority in terms of its goals and ways of operating and the degree to which they are sympathetic to the enterprise and open to its influence. Two postures, capitulation and commitment, are sympathetic postures, the former because resistance to authority seems useless, and the latter because paying tax is seen to be a noble action.

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<sup>89</sup> Letter titled 'Operation Avoidance' to the Regional Controller, Northern from Reg Booth, Project Manager dated 11 February 1994.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

<sup>92</sup> Executive Summary of the Booth Report, (1994) [1.4].

<sup>93</sup> Booth Report, (1994) [4.8].

<sup>94</sup> Inland Revenue Compliance Focus 2011-12.

<sup>95</sup> Doreen McBarnet, 'When Compliance is not the Solution but the Problem: From Changes in Law to Changes in Attitude' in Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (2003) 229.



Three other postures represent the placing of greater distance between the tax office and taxpayers. Resistance reflects the posture of those who are within the system but object strongly to the way it is operating, disengagement reflects the posture of those who have cut themselves off completely from the system and want nothing more to do with it, and game playing reflects detachment with effective defiance. Those who adopt the game playing posture relax the social distance constraints to the point where they can obtain the information they need to beat the tax office at its own game. Game playing is about tax avoidance, in essence, finding ways of legally using law against the tax authority and sidestepping the obligation to pay tax.<sup>96</sup> The concerns raised in the Oomen Report support the adoption of this posture in relation to Mr Russell.

The Compliance Model has both the deference postures of commitment and capitulation as well as the defiance postures of resistance, disengagement and game playing.<sup>97</sup> Ambiguity surrounding what it means to comply with tax law, together with social divisions over the morality of taxation has allowed the motivational posture of game playing to flourish. This posture is not easily managed by regulators because it focuses on the grey areas of tax law, areas where administrators are uncertain and taxpayers see opportunity. Taxpayers who game authorities find clever ways of complying on strictly technical grounds while visibly thumbing their nose at the spirit of the law. This is perhaps why there has been a natural tension between s BG 1 ITA 2007 (and its predecessors) and the more specific provisions of the ITA 2007 (and its predecessors). More recent examples in New Zealand have been the *Chelle Properties (NZ) Limited v Commissioner of Inland Revenue*<sup>98</sup> GST case where tension existed between the timing of input tax claims, and *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue* (2009)<sup>99</sup> where the Supreme Court held that due to the presence of certain unnecessary features in the arrangement, the taxpayer's compliance with specific deduction provisions was not within Parliament's purpose.

To engage with a tax authority successfully, a 'game player' must have a mastery of tax law and be able to successfully engage in the court process. The game playing posture can sit anywhere along the left axis of the Inland Revenue's Compliance Model indicating quite clearly that a taxpayer may be 'willing to do the right thing' and yet cause Inland Revenue considerable angst. Mr Russell adamantly considers that he has complied with the relevant legislation by way of what the statute actually says in the specific sections, such as the loss offset provisions.<sup>100</sup>

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<sup>96</sup> Valerie Braithwaite, Friedrich Schneider, Monika Reinhart and Kristina Murphy, 'Charting the Shoals of the Cash Economy' in Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (2003) 93, 97.

<sup>97</sup> At an individual level, compliance is not a static, uncomplicated phenomenon. People can move in and out of compliance, often through ignorance and apathy, rather than calculative design. The job of regulators is to keep taxpayers more 'in' than 'out'. The Inland Revenue Compliance Model is a tool used to assist in this ongoing process. For more on this topic see , Braithwaite (ed), *Taxing Democracy, Understanding Tax Avoidance and Evasion* (2003).

<sup>98</sup> *Chell'e Properties (NZ) Limited v Commissioner of Inland Revenue* (2004) 21 NZTC 18,618 (HC); (2007) 23 NZTC 21,442 (CA)

<sup>99</sup> *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188 (SC); *Accent Management Limited v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC); (2007) 23 NZTC 21,323 (CA).

<sup>100</sup> Section 188 [Losses incurred may be set off against future profits] and s 191 [Companies included in Group of Companies] Income Tax Act 1976.

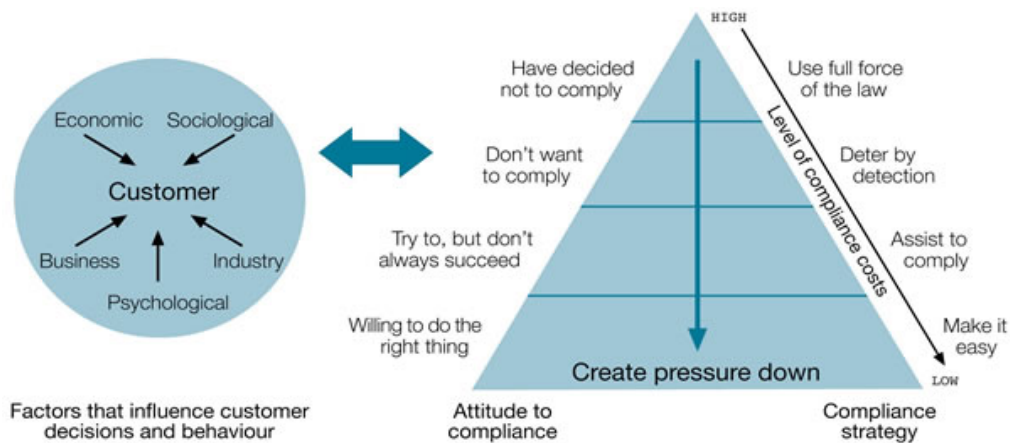


Figure 1: Inland Revenue Compliance Model (source: Inland Revenue).

Braithwaite<sup>101</sup> states that the management of game playing is bound to be difficult, and currently the psychology of game playing is lacking the theoretical infrastructure that has been built around other postures. Different motivational postures can be held simultaneously so it is relatively easy for them to wax and wane over time. Braithwaite states by way of example that when instructions arrive in the mail for a yearly tax return we might feel committed, or at least capitulate to the system. As we look in detail at how much tax we have paid or owe, we might feel resistance, disengagement or perhaps even a desire to play games. Having completed the transaction, however, we might revert to our committed posture, believing that paying tax is the right thing to do. In other words, as the context in which we find ourselves changes, our motivational postures change, making us cooperative at times, uncooperative at other times.<sup>102</sup> One can only assume that the continual requests for information directed to Mr Russell and his entities over time, as well as a tax outstanding amount that has grown beyond the realms of being able to be paid, has contributed to a posture of game playing, where although the stakes are high, in reality Mr Russell has no ability to pay the amount that appears on his Inland Revenue Statement of Account.

Braithwaite, referring to the multiple postures a taxpayer can hold, and observing that postures can change, states: <sup>103</sup>

There is evidence that those that are persistently resistant can go towards being disengaged or game players. They don't start out as being disengaged or game players, but a grievance such as '*they've got a vendetta against me*' may facilitate the change in posture. At some level a taxpayer does care that the tax authority have pursued him in this way, so there's the resistance, there's the component of resistance, but combined with that there's something else, so with those postures of game playing and disengagement there's often big ideological ideals and particular attitudes to that authority and I know what it is in the tax context and that is that it is driven by a desire to win at all costs, now in my more colourful moments I have called it narcissism...

<sup>101</sup> Interview with Valerie Braithwaite, December 2008, Australian National University.

<sup>102</sup> Valerie Braithwaite, 'Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions', Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (2003), 15, 23.

<sup>103</sup> Interview with Valerie Braithwaite, Australian National University, 4 December 2008.

With regard to the context of time, by reference to the lower Court decisions of *Challenge*,<sup>104</sup> coupled with Inland Revenue's granting of approval for the selling of tax losses as being relatively commonplace, Mr Russell can justify the template arrangement, and, in some respects, his position that he has followed the law and has been at the 'willing to do the right thing' part of the Compliance Model (see Figure 1 'Compliance Model' above). From a timeline perspective the Russell template was applied from the early 1980's, with the last template clients in 1986, whereas the 4:1 Privy Council decision of *Commissioner of Inland Revenue v Challenge Corporation Limited*<sup>105</sup> was released in 1986.

Although the Compliance Model has been in existence for quite some time, Mr Russell's first glance at the Model was during an interview with the author in early 2010. He considered that he sat on the bottom of the 'pyramid' along with most taxpayers regarding himself as clearly being 'willing to do the right thing'. He considered that Inland Revenue had a completely separate category for him well above the 'use full force of the law' compliance strategy. Logically, this suggests that a taxpayer's perceptions of where they sit on the Model and Inland Revenue's perceptions of the taxpayer can naturally be quite distant.

## IX CONCLUSION

Mr Russell 'officially' retired in 1999. One thing that is not often considered is the personal time and toll that the template and associated litigation has taken on Mr Russell and his family. Mr Russell admits that there was a cost to family life with the long hours spent at the office during his working life.<sup>106</sup> With litigation spanning over so many years, and with the cost estimated at NZD \$5 million to defend the template only being part of the story, there is also the psychological cost of time and worry. Clearly one would have to be motivated to keep going with this type of litigation. Many people would have simply given up. Mr Russell described the ongoing litigation as 'a bit like being pregnant...you really have to see it through.'

It is doubtful whether Inland Revenue will recoup much of the funds it seeks to collect. The ultimate outcome after years of litigation may be bankruptcy for Mr Russell. However, even though this is the outcome he would not necessarily wish for, at least his retirement years may become a little more peaceful without the frequent section 17 TAA requests arriving in the mail.<sup>107</sup> It will remain, like the initial template 'Track A' case outcomes, perhaps a 'pyrrhic' victory for Inland Revenue if they are successful in the final round of the template litigation.

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<sup>104</sup> *Challenge Corporation Limited v Commissioner of Inland Revenue* (1984) 6 NZTC 61,807; *Commissioner of Inland Revenue v Challenge Corporation Limited* (1986) 8 NZTC 5,001

<sup>105</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited* [1986] 2 NZLR 513; (1986) 8 NZTC 5,219.

<sup>106</sup> Mr Russell made the comment during an interview on 27 January 2010 that working such long hours had taken a toll on the time he had spent with his children when they were younger, especially during the Securitibank years.

<sup>107</sup> Five s 17 Notices to Furnish Information arrived on the day of my second interview with Mr Russell in April 2010.

In relation to having any regrets in life Mr Russell replied to the author, after taking a moment to reflect, 'I don't think so...' and went on to say:

'I would have rather not have had this row with Inland Revenue, but I don't see how you can...the point is I firmly believe if it hadn't been over the Russell template it would have been over something else...' <sup>108</sup>

From a personal time perspective Mr Russell said the template litigation and associated matters have occupied more than half his time for a period of around 26 years.

As far as a life outside of the 'tax wars', Mr Russell still plays the organ in the local Presbyterian Church and tries to maintain his health. Although Mr Russell's intention is to try to retire from the ongoing 'tax war' within 12 months, he thinks that might be a bit of wishful thinking. With regard to his greatest achievement he states 'tongue in cheek': 'I think staying alive with all this...survival is probably the greatest achievement...' <sup>109</sup>

When asked when the litigation will end he replies that it is up to Inland Revenue. He does not think it will end within the next year or so. In fact, with regard to the Track 'E' litigation he thinks it will go on for a while yet.

Mr Russell continues with a touch of humour:

...so you have to be realistic about the prospects...but you know...I'm certainly determined to battle it out...because I believe that they have got no case...and if it is going to end up that I have a bill for \$138 million<sup>110</sup> [see following] that they have got up to now...well, you know...I will have to start saving up obviously...

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<sup>108</sup> One of the interview questions I had written was to discuss with Mr Russell the 'Track A to E arguments'. I asked him during our interview if a 'Track F' was yet to come. He replied 'yeah, there might be a track F...they will never give up...whereas they live forever...I don't...and the idea is to get rid of me...one way or another!'

<sup>109</sup> Interview with Mr John Russell, Kawakawa Bay, 29 April 2010.

<sup>110</sup> The Inland Revenue Statement of Account for November 2011 has a payment due total of \$177,177,400.00 payable immediately.

PLEASE DISREGARD THIS REQUEST FOR PAYMENT IF THE ACCOUNT HAS BEEN PAID.

● Use the payment slip below when paying. Tear off here ▼ Keep this top part for your records.



**Inland Revenue**  
Te Tari Taake

**Payment slip**

IRD number [REDACTED]

MR  
JOHN GEORGE RUSSELL

Post your payment in the Inland Revenue envelope provided to: P O BOX 1535 HAMILTON

INCOME TAX	Payment due	IMMEDIATELY	\$138,796,819.38
If the payment you're making is different from the payment due write the details here.	Year/period	Tax type	Amount \$
	Total payment made		▶

**Inland Revenue, *Statement of Account*, April 2010**

Mr Russell, commenting about the prospect of Inland Revenue collecting some of the tax, states that Inland Revenue thought that he was worth at least NZD \$80 million. He claims, however, that he is:<sup>111</sup>

‘not worth anything really...in money terms...the house, the motor car for what it’s worth...I don’t even own them...I have never owned them...the trust has always owned them...and so the prospects of them getting any more money are...pretty remote’.

Mr Russell considers it was never really about the money for Inland Revenue – it was about getting rid of him.

The litigation continues.

<sup>111</sup> Interview with Mr John Russell, Kawakawa Bay, 29 April 2010.

## **RESOLVING SMALL TAX DISPUTES IN NEW ZEALAND – IS THERE A BETTER WAY?**

ANDREW J MAPLES\*

### **ABSTRACT**

The current tax disputes resolution procedure, introduced in New Zealand (NZ) with effect from 1 October 1996, includes an extensive pre-assessment phase – the aim of which is to resolve tax disputes without the need for litigation. While this objective of the regime arguably has been achieved it has come at a price for taxpayers; in particular the costs of the new process are such that some tax disputes are not worth pursuing with taxpayers preferring to concede their dispute with Inland Revenue.

In response to concerns raised by commentators and professional organisations about the operation of the disputes resolution process, in 2010 Inland Revenue released an Issues Paper for consultation. This included a cursory and, in the author's view, dismissive review of the approaches in Australia, Canada and the United Kingdom to dealing with small tax disputes. This article reviews the small tax dispute resolution processes adopted in these countries and concludes a separate forum or procedure for such disputes is worthy of further consideration in NZ.

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## I INTRODUCTION

In 1994 the Organisational Review of the Inland Revenue Department (the Richardson Committee),<sup>1</sup> headed by Sir Ivor Richardson, conducted a general review of the operations of the Inland Revenue Department (Inland Revenue). Its review included consideration of the way tax issues between taxpayers and Inland Revenue were managed. The Richardson Committee found a number of shortcomings with the existing process including the time and high cost required to resolve a dispute. The process did not support the early identification and prompt resolution of issues.<sup>2</sup> A new disputes resolution process aimed at resolving disputes fairly and quickly was recommended.<sup>3</sup> The Richardson Committee believed that the disputes resolution process should be more accessible to a greater number of taxpayers, and include a simple fast-track, non-precedential procedure for dealing with small claims to be administered by the Taxation Review Authority (TRA).<sup>4</sup> The new disputes resolution process, based on the Richardson Committee's proposals, came into effect from 1 October 1996.

A review of the disputes resolution process was conducted in 2003 by Inland Revenue.<sup>5</sup> Based on both the declining number of audited cases that were disputed and the cases being litigated this review concluded that the process appeared 'to a significant extent to be meeting its objectives'.<sup>6</sup> Submissions on the Discussion Document were less positive, with concerns relating to the cost and time required to complete the disputes resolution process.<sup>7</sup> The changes made<sup>8</sup> - effective generally from 1 April 2005 - overall did not address the problems with the process.<sup>9</sup>

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<sup>1</sup> Organisational Review Committee, *Organisational Review of the Inland Revenue Department*, (Wellington, New Zealand Government, 1994), ch 10. For an outline of the process pre-October 1986 see Inland Revenue, *Resolving Tax Disputes: Proposed Procedures* (Wellington, New Zealand Government, 1994), ch 2.

<sup>2</sup> Inland Revenue, above n 1, 4.

<sup>3</sup> Organisational Review Committee, above n 1, [10.5].

<sup>4</sup> Ibid, [10.7]. A Taxation Review Authority (TRA) is a one-member authority that sits as a judicial authority for hearing and determining objections and challenges to assessments of tax and to other decisions or determinations of the Commissioner of Inland Revenue as authorised by the Inland Revenue Acts. The TRA system is designed to provide a fair, efficient and cost effective mechanism for the independent adjudication of tax disputes.

<sup>5</sup> Inland Revenue, *Resolving tax disputes: a legislative review - A government discussion document*, (Wellington, New Zealand Government, 2003), 2 (the Discussion Document).

<sup>6</sup> Ibid, 2. The Inland Revenue observed: 'In 1997, the proportion of audited cases giving rise to a dispute was two percent of total cases. This dropped to 0.91 percent in 2002.': ibid 2.

<sup>7</sup> PricewaterhouseCoopers, *Submission on the 2003 legislative review* (2003); Ernst & Young, *Submission on the 2003 legislative review* (2003); Brookfields Lawyers, *Submission on the 2003 legislative review* (2003).

<sup>8</sup> The amendments, which were aimed at ensuring that the disputes resolution process is more accessible to taxpayers and that the costs incurred in preparing the various documents are no greater than is necessary for each particular case, included (i) simplifying the documentation required by both parties to progress a dispute; (ii) extending the time for taxpayers to initiate a dispute to their self-assessment from two months to four months; (iii) introducing a more accessible small claims process which included raising the threshold for such cases from NZ\$15,000 to NZ\$30,000, and (iv) allowing the disputes process to be stayed pending the outcome of a test case if both parties agree. For a discussion of the amendments to the disputes resolution process see also Inland Revenue, 'Disputes Resolution Process' (2005) 17:1 *Tax Information Bulletin* 53.

<sup>9</sup> The Taxation Committee of New Zealand Law Society and The National Tax Committee of New Zealand Institute of Chartered Accountants, *Joint Submission: The Disputes Resolution Procedures in Part IVA of the*

In 2008, due to continuing concerns over the operation of the process,<sup>10</sup> the Taxation Committee of the New Zealand Law Society (NZLS) and the National Tax Committee of the New Zealand Institute of Chartered Accountants (NZICA) co-authored a submission<sup>11</sup> (the Joint Submission) to the Minister of Revenue and the Commissioner of Inland Revenue (CIR), expressing serious concerns about the current process and calling for urgent change. Among its observations, the Joint Submission commented that existing mechanisms for dealing with small claims were inadequate, resulting in abandonment of such disputes by taxpayers:

Our experience is that in effect Inland Revenue may issue questionable matters below the [sic] \$25,000 with impunity, as Inland Revenue knows that it will cost the taxpayer more than that [to] proceed through the disputes resolution procedures and to challenge the Inland Revenue's position in Court. Effectively taxpayer's are 'burned off' by the high costs imposed by the disputes resolution procedures.<sup>12</sup>

As a result taxpayers with small tax disputes 'have no forum for their disputes to be considered'.<sup>13</sup>

In response to the Joint Submission, and in close collaboration with NZLS and NZICA, Inland Revenue began an internal review of the disputes process. This resulted in the implementation of administrative changes effective 1 April 2010<sup>14</sup> - and the subsequent release of two revised Standard Practice Statements (SPS) in November 2010<sup>15</sup> - as well as the publication by Inland Revenue and the New Zealand Treasury of an issues paper

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*Tax Administration Act 1994 and the Challenge Procedures in Part VIIIA of the Tax Administration Act 1994* (Wellington, August 2008) 4,  
<[http://www.lawsociety.org.nz/\\_data/assets/pdf\\_file/0017/4418/Taxation Administration Act Dispute Resolution Procedures.pdf](http://www.lawsociety.org.nz/_data/assets/pdf_file/0017/4418/Taxation_Administration_Act_Dispute_Resolution_Procedures.pdf)>.

<sup>10</sup> Joanne Dunne, 'Tax Disputes Procedure: Legislative change is needed' (April 2009) 17 *Taxation Today* 1; Hon. Justice William Young, 'Tax Disputes in New Zealand' (Paper presented at the Annual Australian Tax Teachers Association Conference, Christchurch, 19-21 January 2009); Greg Blanchard, 'The Case for a Simplified Tax Disputes Process' (2005) 11(4) *New Zealand Journal of Taxation Law and Policy* 417; Mark Keating, 'New Zealand's Tax Dispute Procedure - Time for a change' (2008) 14(4) *New Zealand Journal of Taxation Law and Policy* 425; Aylton Jamieson, 'Brave New World Mark III ... are we there yet?' (November 2007) *Chartered Accountants Journal* 56; James Coleman, 'Tax Update: Disputes Procedure' (December 2007) *New Zealand Law Journal* 407.

<sup>11</sup> NZLS and NZICA, above n 9. See also NZICA and NZLS, *Dispute Resolution Procedures and Challenge Procedures* (Wellington, 4 August 2008) 1,  
<[http://www.nzica.com/AM/Template.cfm?Section=Other\\_Issues\\_Files&Template=/CM/ContentDisplay.cfm&ContentID=13180](http://www.nzica.com/AM/Template.cfm?Section=Other_Issues_Files&Template=/CM/ContentDisplay.cfm&ContentID=13180)>.

<sup>12</sup> NZLS and NZICA, above n 9, 6. The Joint Submission also notes that: 'The effect of the increased costs under the new system is reflected in the statistics - in the year ended 30 June 1996 there were 64 cases taken to the Taxation Review Authority. By 2006 this had dwindled to 13.': *ibid* 6.

<sup>13</sup> *Ibid* 7.

<sup>14</sup> Inland Revenue, *Changes to the disputes resolution process*, (Wellington, June 2010)  
<<http://www.ird.govt.nz/technical-tax/general-articles/changes-to-disputes-res-proc.html>>.

<sup>15</sup> Inland Revenue, 'SPS 10/04: Disputes resolution process commenced by the Commissioner of Inland Revenue' (2010) 22(11) *Tax Information Bulletin* (SPS 10/04) <<http://www.ird.govt.nz/technical-tax/standard-practice/disputes/sps-10-04-disputes-commenced.html>>; Inland Revenue, 'SPS 10/05 Disputes resolution process commenced by a taxpayer' (2010) 22(11) *Tax Information Bulletin* (SPS 10/05) <<http://www.ird.govt.nz/technical-tax/standard-practice/disputes/sps-10-05-disputes-bytaxpayer.html>>. Standard Practice Statements are issued by the Inland Revenue and describe how it will exercise its statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

*Disputes: a review – an officials’ issues paper*<sup>16</sup> (the Issues Paper) in July 2010. The Issues Paper outlined a number of options to address concerns with the current process including conference facilitation, limiting CIR-initiated Notices of Proposed Adjustment (NOPA)<sup>17</sup> to 30 pages and an opt-out option for taxpayers. NZLS and NZICA jointly formulated a response to the Issues Paper in September 2010 (the September Submission),<sup>18</sup> which provided mixed support for the proposals outlined. In November 2010, the Taxation (Tax Administration and Remedial Matters) Bill 2010 (NZ)<sup>19</sup> was introduced into Parliament incorporating proposals from the Issues Paper, including the abolition of the small claims jurisdiction of the TRA. This Bill was subsequently enacted in August 2011 as the *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ). The purpose of this article is not to consider the changes proposed in the Issues Paper and ultimately enacted in the *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ) except where they may impact on the resolution of small tax disputes discussed in this article.

A disputes procedure that is accessible to all taxpayers is vital to the proper functioning of the tax system. Tax compliance research<sup>20</sup> shows that a number of factors may influence taxpayers’ level of compliance, including taxpayers’ perceptions of the fairness of the tax system.<sup>21</sup> One aspect of fairness<sup>22</sup> is procedural justice, which ‘concerns the

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<sup>16</sup> Inland Revenue and the Treasury, *Disputes: a review – an officials’ issues paper* (Wellington, July 2010).

<sup>17</sup> The NOPA is the first formal step in the disputes process and is issued by either the CIR or taxpayer to the other advising that an adjustment is sought to the taxpayer’s assessment, the CIR’s assessment or a disputable decision.

<sup>18</sup> NZLS and NZICA, *Disputes: A Review, July 2010* (Wellington, 3 September 2010) <<http://www.nzica.com/Technical%20and%20business/Tax/Tax%20submissions/~media/NZICA/Docs/Tech%20and%20Bus/Tax/submissions/DisputesReviewAnOfficialsIssuesPaperJuly2010.ashx>>.

<sup>19</sup> The NZLS and NZICA’s joint submission on the Taxation (Tax Administration and Remedial Matters) Bill 2010 (NZ), dated 11 February 2011, can be viewed at

<<http://www.nzica.co.nz/Technical%20and%20business/Tax/Tax%20submissions/~media/NZICA/Docs/Tech%20and%20Bus/Tax/other/Joint%20Final%20%20Submission%20re%20Taxation%20Tax%20Administration%20and%20Remedial%20Matters%20Bill%202010211.ashx>>.

<sup>20</sup> See for example, Betty Jackson and Valerie Milliron, ‘Tax compliance research, findings, problems and prospects’ (1986) 5 *Journal of Accounting Literature* 125 and Maryann Richardson and Adrian Sawyer, ‘A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects’ (2001) 16 *Australian Tax Forum* 137.

<sup>21</sup> See for example Joachim Vogel, ‘Taxation and Public Opinion in Sweden: An Interpretation of recent survey data’ (1974) 27 *National Tax Journal* 499; Michael Spicer and Sven Lundstedt, ‘Understanding tax evasion’ (1976) 31 *Public Finance* 295; Michael Spicer and Lee Becker, ‘Fiscal Inequity and tax evasion: An experimental approach’ (1980) 33 *National Tax Journal* 171; Thomas Porcano, ‘Correlates of tax evasion’ (1988) 9 *Journal of Economic Psychology* 47; Wilbur Scott and Harold Grasmick, ‘Deterrence and income tax cheating: Testing interaction hypotheses in utilitarian theories’ (1981) 17 *Journal of Applied Behavioral Science* 395; Amitai Etzioni, ‘Tax Evasion and Perceptions of Tax Fairness: A Research Note’ (1986) 22(2) *The Journal of Applied Behavioural Science* 177; Peggy Hite, ‘An examination of the impact of subject selection on hypothetical and self reported taxpayer noncompliance’ (1988) 9 *Journal of Economic Psychology* 445; Lin Mei Tan, ‘Taxpayers’ Perceptions of Fairness of the Tax System – A Preliminary Study’ (1998) 4(2) *New Zealand Journal of Taxation Law and Policy* 59; Michael Roberts, ‘An Experimental Approach to Changing Taxpayers’ Attitudes Towards Fairness and Compliance via Television’ (1994) 16(1) *The Journal of the American Taxation Association* 67 and George Gilligan and Grant Richardson, ‘Perceptions of Tax Fairness and Tax Compliance in Australia and Hong Kong: A Preliminary Study’ (2005) 12(4) *Journal of Financial Crime* 331.

<sup>22</sup> Saad identifies a number of dimension including vertical fairness, horizontal fairness, policy fairness, exchange fairness, a preference for either progressive or proportional taxation, personal fairness, tax rate fairness, procedural fairness, special provisions and general fairness: Natrah Saad, ‘Fairness Perceptions

perceived fairness of the procedures involved in decision-making and the perceived treatment one receives from a decision maker.<sup>23</sup> In the New Zealand context, if small tax disputes are not being heard due to the costly and cumbersome nature of the resolution process, the affected taxpayers may perceive that they have not been treated fairly by Inland Revenue (and the tax system) which ultimately may impact on the level of the taxpayer's on-going compliance.<sup>24</sup> This is especially important given the potentially large number of small tax disputes. According to the Richardson Committee two-thirds of tax disputes (at that time) were concerned with amounts of less than NZ\$10,000<sup>25</sup> - adjusted for inflation, this figure would be equivalent to NZ\$15,050 in 2011.<sup>26</sup> The September Submission observes that it would be uneconomic to take a dispute for this amount and that these small 'disputes do not disappear, they are left to fester'.<sup>27</sup>

A number of studies<sup>28</sup> also indicate that revenue authority contact may have an impact on taxpayer compliance. The disputes resolution process, with its numerous interactions with Inland Revenue, can be stressful and potentially intimidating for taxpayers and may contribute to negative perceptions of the tax system and revenue authority. In addition, the current procedural requirements of the disputes resolution process make no concession for the size of the dispute or its complexity.<sup>29</sup> The September Submission, noting taxpayers are priced out of a disputes process which also delays their access to justice, pertinently observed that these issues are 'cementing the view of taxpayers that the system is weighted against them and that there is no point in pursuing disputes. This is undermining the integrity of the tax system.'<sup>30</sup>

The next section contains a brief overview of the disputes resolution process including the small claims process. Section 3 outlines concerns with the (former) small claims jurisdiction of the TRA. The purpose of this article is not to develop a definitive proposal for the resolution of small (or very small) tax disputes in New Zealand<sup>31</sup> but to consider

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and Compliance Behaviour: The Case of Salaried Taxpayers in Malaysia after Implementation of the Self-Assessment System' (2010) 8(1) *eJournal of Tax Research* 32, 35 <[http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper3\\_v8n1.pdf](http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper3_v8n1.pdf)>.

<sup>23</sup> Kristina Murphy, 'Regulating More Effectively: The Relationship between Procedural Justice, Legitimacy, and Tax Non-compliance' (2005) 32(4) *Journal of Law and Society* 562, 566.

<sup>24</sup> The Issues Paper recognised that the costs of the current system were 'likely to have repercussions for the integrity of the tax system, because the affected taxpayers may come to have less faith in its overall fairness.': Inland Revenue and the Treasury, above n 16, 43.

<sup>25</sup> Organisational Review Committee, above n 1, [10.8].

<sup>26</sup> Based on the Reserve Bank of New Zealand *New Zealand Inflation Calculator* <<http://www.rbnz.govt.nz/statistics/0135595.html>> at 26 April 2011.

<sup>27</sup> NZLS and NZICA, above n 18, [3.28].

<sup>28</sup> Jackson and Milliron, above n 20, 139-140, Richardson and Sawyer, above n 20, 188-192; Ronald Worsham, 'The effect of tax authority behaviour on taxpayer compliance: a procedural justice approach' (1996) 18 *Journal of American Taxation Association* 19-39 and Karyl Kinsey, 'Deterrence and alienation effects of IRS enforcement: an analysis of survey data' in Joel Slemrod, (ed.), *Why people pay taxes: tax compliance and enforcement* (University of Michigan Press, 1992) 259, as cited in Richardson and Sawyer, above n 20, 191.

<sup>29</sup> NZLS and NZICA, above n 18, [3.49].

<sup>30</sup> *Ibid* [2.3].

<sup>31</sup> For consideration of a possible solution for dealing with small tax disputes in New Zealand see James Peck and Andrew Maples, 'The Disputes Resolution Process in New Zealand: What about the little fellas?' (2010) 16(4) *New Zealand Journal of Taxation Law and Policy* 348.

the approaches of Australia, Canada and the United Kingdom (UK) to resolving small disputes (Section 4), and highlight key principles from the survey of these three jurisdictions (Section 5). Concluding comments are made in Section 6.

## II THE DISPUTES RESOLUTION PROCESS

While the disputes resolution process can be initiated by either the CIR or taxpayer issuing a NOPA, it is usually the CIR who will initiate the process. Accordingly this section is primarily written on the basis of that assumption, but with references to taxpayer initiated disputes as appropriate.

The disputes resolution process, which is essentially prescribed in Part IVA of the *Tax Administration Act 1994 (NZ)*<sup>32</sup> contains an extensive pre-assessment phase, comprising the exchange of the following documents by the taxpayer and Inland Revenue: NOPA,<sup>33</sup> Notice of Response (NOR),<sup>34</sup> Disclosure Notice<sup>35</sup> and Statements of Position (SOP).<sup>36</sup> These documents are designed to ensure that taxpayers and Inland Revenue operate on an 'all cards on the table' basis and to give the parties every possible opportunity to resolve their differences before heading down the path of judicial determination.<sup>37</sup> The procedures include set time frames, deemed acceptance of the other party's position if time frames are not met and the 'evidence exclusion rule', which essentially limits both parties in any subsequent litigation to the issues and propositions of law disclosed in their respective SOPs.<sup>38</sup>

The process also includes administrative (non-legislated) procedures - the conference and adjudication phases. If the dispute has not been resolved after the NOR phase, a conference may be held to clarify and if possible, resolve the issues. From 1 April 2010<sup>39</sup> taxpayers can elect to opt-out of the disputes process (and proceed to court) after the conference phase if *inter alia* the core tax in dispute (i.e., excluding shortfall penalties, use of money interest and late payment penalties, if applicable), is NZ\$75,000 or less,

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<sup>32</sup>For more information on the current disputes resolution process refer SPS 10/04 and SPS 10/05: Inland Revenue, above n 15.

<sup>33</sup> New SPS 10/04 states that for disputes involving less than NZ\$5,000 of tax (excluding evasion and tax avoidance issues) CIR NOPA's should not exceed 5 pages: Inland Revenue, above n 15, 73. Where the dispute concerns one issue only (for example the imposition of penalties), CIR's NOPA should not exceed ten pages: *ibid*.

<sup>34</sup> A NOR is issued by the recipient of a NOPA if they disagree with the NOPA.

<sup>35</sup> The Disclosure Notice is issued by the CIR and triggers the application of the 'evidence exclusion rule'.

<sup>36</sup> The SOP is issued by both parties, providing an outline of the issues, facts, evidence and propositions of law with sufficient detail to support the position taken.

<sup>37</sup> Organisational Review Committee, above n 1, [10.11].

<sup>38</sup> Up until 28 August 2011 the evidence exclusion rule limited parties to the facts, evidence, issues and propositions of law disclosed in their respective SOPs. The *Taxation (Tax Administration and Remedial Matters) Act 2011 (NZ)*, with effect from 29 August 2011, amended the evidence exclusion rule so that it now limits parties to only the issues and propositions of law disclosed in their respective SOPs: *Tax Administration Act 1994 (NZ)*, s 138G.

<sup>39</sup> Inland Revenue, above n 14, 1. The opt-out is subject to the taxpayer having meaningfully participated in the conference phase and signed a declaration that they have supplied all material information to Inland Revenue officers directly involved in the dispute, according to SPS 10/4: Inland Revenue, above n 15, [263].



the dispute turns purely on the facts or it is considered the dispute can be resolved more efficiently at a hearing authority.<sup>40</sup>

The revised SPSs<sup>41</sup> provide that conferences can, at the option of the taxpayer, be attended by a facilitator who is an independent senior Inland Revenue officer with 'sufficient technical knowledge to understand and lead the conference meeting.'<sup>42</sup> Their role is to 'assist in focussing the parties on the relevant facts and technical issues, explore options and ensure that all information that should have been disclosed is exchanged at the earliest possible opportunity.'<sup>43</sup> In addition, the facilitator has the ability to determine when the conference phase has come to an end.

Disputes that remain unresolved following the issuing of SOPs are referred to Inland Revenue's Adjudication Unit in Wellington.<sup>44</sup> The unit's function is to consider the dispute impartially and independently of the audit function. If the adjudicator finds in the taxpayer's favour, the dispute will conclude. If the adjudicator agrees with all or any of the adjustments proposed by the CIR, an assessment consistent with these findings will be issued. At this stage the dispute resolution process has been completed. If the taxpayer still wishes to challenge the resulting assessment they may do so by commencing court proceedings within the two-month response period. The dispute could be heard in the TRA – either the general or (formerly) small claims jurisdiction – or the High Court.

Up until (and including) 28 August 2011, a small claims process is an available option for taxpayers who do not wish to proceed down the path of a full court hearing and comes within the jurisdiction of the TRA.<sup>45</sup> This option is available to taxpayers if the amount of tax in dispute is NZ\$30,000 or less, the facts are clear and not in dispute and no significant legal issues of precedent are involved.<sup>46</sup> A non-refundable NZ\$400 fee is payable to file a claim with the TRA small claims jurisdiction. The fee can be waived if the taxpayer is unable to pay or the issue is a matter of public interest.

Decisions of the TRA acting in its small claims jurisdiction are of no precedential value, are not published, and cannot be appealed. This forum may be elected in the taxpayer's NOPA or NOR (for a CIR-initiated dispute). If the taxpayer makes this election it is irrevocable. The CIR can challenge the taxpayer's election and apply to the TRA to have the proceedings transferred to either the general jurisdiction of the TRA or the High Court,<sup>47</sup> or the TRA may require the proceedings to be transferred to its general jurisdiction.<sup>48</sup> Effectively the election circumvents the remainder of the dispute resolution process and allows the dispute to proceed straight to the TRA acting in its small claims jurisdiction.

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<sup>40</sup> Ibid [267] (SPS 10/04).

<sup>41</sup> Ibid [234-238], [247-251] (SPS 10/04) and [165-169], [178] (SPS 10/05).

<sup>42</sup> Ibid [234] (SPS 10/04) and [165] (SPS 10/05).

<sup>43</sup> Inland Revenue and the Treasury, above n 16, 7.

<sup>44</sup> The Adjudication Unit is part of Inland Revenue's Office of the Chief Tax Counsel.

<sup>45</sup> *Tax Administration Act 1994* (NZ), s 89E.

<sup>46</sup> Ibid s 89E(1).

<sup>47</sup> Ibid s 1380(1).

<sup>48</sup> Ibid s 1380(2).



The TRA, in its small claims capacity, cannot award costs for or against the taxpayer or CIR, with the limited exception in respect of costs of the TRA itself, where a challenge is dismissed as being frivolous, vexatious or made solely for delay.<sup>49</sup>

The *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ) abolished the small claims jurisdiction of the TRA with effect from 29 August 2011.

### III A 'LAME DUCK'? - THE OPERATION OF THE TRA SMALL CLAIMS JURISDICTION

There have been concerns expressed over the small claims process<sup>50</sup> - most significantly - that since its establishment in 1996 fewer than ten cases have been heard by the TRA acting in this capacity.<sup>51</sup> The *Taxation (Tax Administration and Remedial Matters) Bill: Commentary on the Bill*<sup>52</sup> (the Commentary on the Bill) states this is due to the fact that 'a dispute has to exhibit certain characteristics before a taxpayer can elect to use the small claims jurisdiction, and there is no right of appeal from the TRA acting in that capacity'.<sup>53</sup>

Three 'characteristics' have clearly limited the use of the small claims process. First, there 'are very few tax cases involving no disputed facts. Often cases will turn on fact patterns, or the parties' interpretation of factual matters.'<sup>54</sup> Second, disputes with matters of legal significance that may have precedential value are not permitted to use the small claims process. Anecdotal evidence suggests that Inland Revenue considers most cases to be of precedential value and therefore ultimately cases involving small disputes are elevated to the TRA or the High Court.<sup>55</sup> The Issues Paper acknowledges even in cases where the facts are clear 'it is often at least arguable that there is a 'significant' legal issue at stake'.<sup>56</sup> Of these two 'characteristics', the September Submission somewhat cynically but aptly observes: 'If the facts are clear and undisputed and there is no significant legal issue, one could well ask what there is to dispute.'<sup>57</sup> Third, the threshold of NZ\$30,000 is too low and therefore excludes many disputes.

The second reason cited by the Commentary on the Bill for the paucity of cases heard in the TRA's small claims jurisdiction is the lack of appeal rights. How important appeal rights are to taxpayers with small tax disputes, especially very small disputes, is a moot

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<sup>49</sup> *Taxation Review Authorities Act 1994* (NZ), s 22.

<sup>50</sup> See for example Keating, above n 10, 428; NZLS and NZICA, above n 9, 6-7; Jamieson, above n 10, 57.

<sup>51</sup> Inland Revenue, *Taxation (Tax Administration and Remedial Matters) Bill: Commentary on the Bill* (Wellington, November 2010) 20, <<http://taxpolicy.ird.govt.nz/publications/2010-commentary-term/overview>>. The Tribunals Unit, Ministry of Justice, has advised the author that only four decisions were decided under the small claims jurisdiction between 2006 and 2009, all of which were decided on the papers.

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid* 20.

<sup>54</sup> Inland Revenue and the Treasury, above n 16, 44.

<sup>55</sup> Somewhat ironically, when recommending a fast-track process for small claims the Richardson Committee believed most small disputes (i.e. amounts of less than NZ\$10,000) were non-precedential: Organisational Review Committee, above n 1, [10.7].

<sup>56</sup> Inland Revenue and the Treasury, above n 16, 44.

<sup>57</sup> NZLS and NZICA, above n 18, [3.30].

point. In the author's view, arguably what this group wants is for their dispute to be heard by an independent party without delay and at minimal cost. It is unlikely, except perhaps for more 'sizeable' small disputes, that these taxpayers would rate the ability to appeal as important and indeed would also be unlikely to appeal a determination if they had the option – to do so would simply delay resolution of the dispute and lead to additional, potentially unwarranted costs (on the basis of the small amount in dispute). The Australian experience (which is outlined in Section 4.B of this article) - where only one appeal was lodged from a decision of its Small Taxation Claims Tribunal in the 2009-2010 year - supports this contention.<sup>58</sup> However, it is acknowledged that there are taxpayers who are litigious in nature and for whom appeal rights, irrespective of the amount of tax in dispute, would be important.

Proposals for reforming the process for resolving small tax disputes have been outlined in the Joint Submission<sup>59</sup> and, for small and very small tax disputes, the September Submission.<sup>60</sup> For small tax disputes, the Joint Submission recommends that taxpayers should be able to file a Notice of Claim and proceed directly to the small claims jurisdiction of the TRA without completing the disputes resolution process.<sup>61</sup> This would reduce the potentially significant costs currently incurred both by the taxpayer and Inland Revenue in preparing the NOPA and NOR.

The September Submission, while supportive of the right for small disputes to opt-out, recommended the right to opt-out should be a legislated right (and also suggested a reduction in the level of formal documentation required).<sup>62</sup> In the case of very small or 'micro' tax disputes – defined as tax in dispute of up to NZ\$50,000 - the September Submission recommends such disputes be heard by way of mediated hearing with unresolved matters either decided by an experienced tax arbitrator or the TRA (which could also run the mediation).<sup>63</sup> A consideration of the Joint Submission and September Submission proposals is beyond the scope of this paper.

The Issues Paper also addressed the resolution of small (and very small) tax disputes. It proposed the repeal of the small claims jurisdiction of the TRA on the basis that the (new) ability for taxpayers to truncate the disputes process – by opting-out of the process after the conference phase<sup>64</sup> - would eliminate the need for a specific taxpayer election to the small claims jurisdiction, because taxpayers will be able to begin a dispute at the earlier stage in the general jurisdiction of the TRA.<sup>65</sup> It 'will result in small claim disputants effectively having a 'fast track' to the TRA.'<sup>66</sup> Further, the Issues Paper suggested this route may be preferable for taxpayers as they will retain their appeal rights and receive the benefits of the facilitated conference.<sup>67</sup> The Issues Paper also

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<sup>58</sup> AAT, *Annual Report 2009-10* (2010) 137 (Table A3.9) (AAT Annual Report).

<sup>59</sup> NZLS and NZICA, above n 9, 17-18.

<sup>60</sup> NZLS and NZICA, above n 18, [3.34], [3.40-3.41] and [3.54-3.57].

<sup>61</sup> NZLS and NZICA, above n 9, 17-18.

<sup>62</sup> NZLS and NZICA, above n 18, [3.33], [3.41].

<sup>63</sup> *Ibid* [3.54-3.57]. In addition, decisions would be non-precedential and taxpayers could elect for this form of dispute resolution without having to proceed through the NOPA/NOR or conference phase.

<sup>64</sup> For example, where the tax in dispute is less than NZ\$75,000.

<sup>65</sup> Inland Revenue and the Treasury, above n 16, 46.

<sup>66</sup> *Ibid*.

<sup>67</sup> *Ibid*.

stated the ability for taxpayers to opt-out of the process after the conference (and new Inland Revenue care and management principles) would effectively deal with 'very small' claims, which are defined as disputes where the tax at issue is NZ\$5,000 or less.<sup>68</sup> Accordingly, in the view of the Issues Paper, there is no need for a specialist tribunal for very small tax disputes.<sup>69</sup> As already noted the small claims jurisdiction of the TRA was abolished by the *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ).

This opt-out process will be 'fast track' in comparison with the current disputes resolution process (through to adjudication). However, it will require taxpayers to take part in a (facilitated) conference, which will add time and cost for taxpayers and will still require taxpayers to file a NOPA or NOR – the same documents as used to commence complex tax disputes.

The Commentary on the Bill observes that the "TRA acting in its general jurisdiction is able to deal with small claims. Disputants can represent themselves and the TRA, as a commission of enquiry, has a large degree of flexibility in the formality or otherwise of hearings."<sup>70</sup> In the author's view, even with small disputes, taxpayers in the TRA will be facing an experienced Inland Revenue litigation team. Further, irrespective of the amount of tax in dispute, as TRA decisions (in the general jurisdiction) are precedential, Inland Revenue will ensure, utilising its vast pool of experienced staff, that their case is well prepared and presented. It will be rare for a taxpayer to have the confidence or ability to represent themselves and argue their case – if they did there would be 'an imbalance of power and knowledge'.<sup>71</sup> In the event that they fail to meet the prescribed procedural requirements Inland Revenue may issue a default assessment and challenge the taxpayer's documentation in court.<sup>72</sup> Further, simply because a dispute may only involve a small amount of money does not mean that the issues are not still complex – a point noted in the 2009-2010 Annual Report of the Australian Administrative Appeals Tribunals (AAT) (see Section 4.B).<sup>73</sup>

Accordingly, it is likely that taxpayers with small tax disputes will still require the services of a legal advocate – in addition to their existing tax advisor, if they have one – to prepare and present their case. This significantly increases the costs of disputing the issue(s) potentially making small and very small tax disputes uneconomic.<sup>74</sup> As a result these taxpayers may still prefer to concede or settle with the CIR at an early stage.

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<sup>68</sup> The NZLS and NZICA do not agree that a small tax sum dispute is one limited to no more than NZ\$5,000: NZLS and NZICA, *Disputes Resolution and Challenge Procedures: National Tax Disputes Process Subcommittee Report – NZLS and NZICA Response* (15 September 2009) 9, <[http://www.lawsociety.org.nz/\\_data/assets/pdf\\_file/0014/12830/Disputes\\_Resolution\\_and\\_Challenge\\_s\\_final\\_version\[D\].pdf](http://www.lawsociety.org.nz/_data/assets/pdf_file/0014/12830/Disputes_Resolution_and_Challenge_s_final_version[D].pdf)>.

<sup>69</sup> Inland Revenue and the Treasury, above n 16, 43.

<sup>70</sup> Inland Revenue, above n 51, 20.

<sup>71</sup> NZLS and NZICA, above n 18, [3.51].

<sup>72</sup> *Ibid* [3.50].

<sup>73</sup> AAT, above n 58, 26.

<sup>74</sup> In Appendix A of the Joint Submission NZLS and NZICA also observe with respect to the decline in tax cases proceeding to court: "This does not mean that people no longer have disputes with Inland Revenue for small amounts of tax – it just means that there is no forum for those cases to be heard, where the tax dispute cannot be heard for less than the cost of the disputes process.": NZLS and NZICA, above n 9, 28.

The Issues Paper considered the approaches of Australia, Canada and the UK to very small claims and rejected some form of tribunal or hearing authority to deal with such disputes for several reasons including adding extra costs to the system and the current inherent flexibility that exists in the TRA in setting its own processes.<sup>75</sup> In addition, the Issues Paper noted that the New Zealand approach to dispute resolution also differs from these countries as the bulk of the process is designed to take place before the assessment is issued.<sup>76</sup> Walker comments that these 'reasons given for dismissing the development in New Zealand of a very small claims forum for tax disputes do not appear insurmountable. Taxpayers may well see this as a missed opportunity for positive reform.'<sup>77</sup>

The Issues Paper briefly canvassed the idea of increasing the existing threshold for hearing small claims in the TRA (to tax in dispute of less than NZ\$75,000) and permitting factual disputes to be heard in the small claims jurisdiction. This proposal is dismissed with little analysis in the Issues Paper, essentially on the grounds that the 'lack of appeal rights would make the election to the small claims jurisdiction more of a 'gamble' for taxpayers.'<sup>78</sup> However, the Issues Paper continues that to allow appeals from the small claims jurisdiction would mean the jurisdiction would differ little from the general TRA jurisdiction.<sup>79</sup> Again, the author questions the assertion that appeal rights are a significant consideration to taxpayers in this category – if they are an issue then taxpayers could simply elect to use the full dispute resolution process rather than the small claims process. It is acknowledged that the finality of decisions in the TRA small claims jurisdiction may be more an issue for Inland Revenue.

In October 2010, the Minister of Revenue announced that the recent operational changes made to the disputes resolution process will be reviewed in two years and should significant taxpayer concerns remain he may consider further legislative change at that time.<sup>80</sup>

#### **IV RESOLUTION OF SMALL TAX DISPUTES – A CONSIDERATION OF OTHER COMMON LAW COUNTRIES**

##### ***A Introduction***

The Richardson Committee identified the need for a specific fast-track non-precedential process to deal with small tax disputes - defined as those claims where the tax in

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<sup>75</sup> Inland Revenue and the Treasury, above n 16, [8.38-8.39].

<sup>76</sup> Ibid [8.35-8.36].

<sup>77</sup> Jarrod Walker, *The Reform of the Tax Disputes Process: The Story Continues* (8 October 2010) <<http://www.bellgully.com/resources/resource.02654.asp>>.

<sup>78</sup> Inland Revenue and the Treasury, above n 16, 46.

<sup>79</sup> Ibid. The Issues Paper also considers but rejects making the small claims jurisdiction compulsory: ibid 47. For very small claims (i.e., where the tax at issue is NZ\$5,000 or less) the Issues Paper canvasses using the Disputes Tribunal (ibid 47-48) or establishing a specialist tribunal (ibid 48-50) to resolve these disputes. Both these options are rejected.

<sup>80</sup> Honourable Peter Dunne, 'Keynote address to the 2010 NZICA Tax Conference' (Speech delivered at the New Zealand Institute of Chartered Accountants Tax Conference, Auckland, October 2009) <<http://taxpolicy.ird.govt.nz/news/2010-10-29-nzica-conference>>.

dispute was less than NZ\$10,000<sup>81</sup> (equivalent to NZ\$15,050 in 2011 adjusted for inflation).<sup>82</sup> It noted simpler, 'fast track' procedures for small claims were available in the tax courts in the United States and Canada and a recommendation had been made for the establishment of a small taxation claims tribunal to deal with small tax disputes in Australia. According to the Richardson Committee, two-thirds of all tax disputes at that time concerned amounts less than this threshold and most would be non-precedential.<sup>83</sup> The Richardson Committee accordingly saw the resolution of small tax disputes as very important, and clearly envisaged a significant number of disputes being heard through a streamlined, focused process. The September Submission also favourably refers to examples used in Australia, Canada and the UK to resolve very small tax cases.<sup>84</sup> This section of the article outlines the approaches to resolving small tax disputes in these three jurisdictions. Key findings from the survey of the three jurisdictions are summarised in 'Table A: Small Tax Disputes – A Comparison' at the conclusion of this section.

In this part of the article the author uses the terms 'taxpayer', 'applicant' and 'appellant' interchangeably and the relevant revenue authority title and 'respondent' interchangeably as invariably (but not always), the appeal proceedings will be commenced by the taxpayer.

## B Australia and the Small Taxation Claims Tribunal

The Small Taxation Claims Tribunal (STCT), which is part of the Taxation Appeals Division of the AAT,<sup>85</sup> commenced operation on 1 July 1997. The STCT, which was established under Part IIIAA of the *Administrative Appeals Tribunal Act 1976* (Cth)<sup>86</sup> is **independent** of the Australian Taxation Office (ATO). It was created 'to provide a cheaper and more informal means for taxpayers to obtain merits review of taxation decisions'.<sup>87</sup>

The STCT can review decisions of the ATO:

- if the amount of tax in dispute is less than A\$5,000<sup>88</sup> (equivalent to NZ\$6,560),<sup>89</sup> or
- for refusing an individual's request to be released from paying a tax debt (irrespective of the amount involved).<sup>90</sup>

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<sup>81</sup> Organisational Review Committee, above n 1, [10.7], [10.11].

<sup>82</sup> Based on the Reserve Bank of New Zealand *New Zealand Inflation Calculator*, <<http://www.rbnz.govt.nz/statistics/0135595.html>> at 26 April 2011.

<sup>83</sup> Organisational Review Committee, above n 1, [10.7].

<sup>84</sup> NZLS and NZICA, above n 18, [3.44-3.46].

<sup>85</sup> The AAT was established by the *Administrative Appeals Tribunal Act 1976* (Cth) and commenced operations on 1 July 1976.

<sup>86</sup> *Administrative Appeals Tribunal Act 1976* (Cth), ss 24AA to 24AD.

<sup>87</sup> AAT, *Small Taxation Claims Tribunal Practice Direction* <<http://www.aat.gov.au/PracticeDirectionsAndGuides/SmallTaxationClaimsTribunalPracticeDirection.html>>.

<sup>88</sup> In cases where the tax in dispute exceeds this threshold, the matter is heard by the AAT's Taxation Appeals Division.

<sup>89</sup> Using a cross rate A\$1 = NZ\$1.312,

<[http://money.msn.co.nz/currencyconverter.aspx?cmp=gl\\_nz1\\_CurrencyCalculator&mch=sem](http://money.msn.co.nz/currencyconverter.aspx?cmp=gl_nz1_CurrencyCalculator&mch=sem)> at 5 January 2011.



Before the STCT can review these decisions, the taxpayer must have requested the ATO reconsider the decision again by lodging an objection. The STCT can review the decision made by the ATO on the objection.

Applications for the dispute to be heard by the STCT can be made by the taxpayer to the STCT, in either an application form<sup>91</sup> or a letter,<sup>92</sup> along with a copy of the ATO decision they are disputing and can be lodged electronically.<sup>93</sup> If the amount of tax in dispute is not stated in the application the review will be conducted by the AAT's Taxation Appeals Division. Applications to the STCT must be made within 60 days of receiving the ATO's objection decision and must be accompanied by a non-refundable fee of A\$77 (equivalent to NZ\$100.99).<sup>94</sup> In the event that the time limit for making an application has expired the taxpayer may apply for an extension of time.

Within 14 days of receiving notice of a STCT application, the ATO will lodge with the Tribunal the documents required under section 37 of the *Administrative Appeals Tribunal Act 1976* (Cth) (Section 37 Documents) and send copies of these documents to the applicant.<sup>95</sup> These documents comprise those papers which are relevant to the ATO's decision. The applicant must ensure that any relevant information, such as financial records or other documents not included in the Section 37 Documents, is available to bring to the first conference, or make arrangements to allow the ATO to inspect the documents before the first conference if it is impractical to bring the information to the first conference.

In most cases, the first step in a review is a pre-trial [conference](#) which is an informal meeting conducted by the AAT (before a Tribunal member or Conference Registrar) with the taxpayer (with representation if necessary) and an ATO officer. It will be held between four and six weeks after the taxpayer's application is lodged.<sup>96</sup> The conference is an opportunity for discussion of the issues in dispute, the facts surrounding those issues, any relevant information that the applicant has brought and the need to obtain any further evidence. The STCT will, where possible, attempt to help the parties reach an agreement about the resolution of the case. If the dispute is not resolved at the first conference, a hearing date will be set (even if a second conference is to take place). The hearing date will be within 6 weeks of the first conference.

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<sup>90</sup> The STCT can also review decisions made by the ATO refusing a request for an extension of time within which to make an objection if the taxpayer is late in filing the objection.

<sup>91</sup> AAT, *Application for Review of Decision* <[http://www.aat.gov.au/docs/form1\\_Nov10.pdf](http://www.aat.gov.au/docs/form1_Nov10.pdf)>. The September Submission observes that the form fits on two sheets of A4 paper: NZLS and NZICA, above n 18, [3.44].

<sup>92</sup> The letter must include the taxpayer's personal details (name, address, telephone number and date of birth), the decision reference, the date of the decision and the date it was received by the taxpayer and brief reasons why the taxpayer believes the decision is wrong, and the amount of tax in dispute (if the taxpayer want the STCT to review a decision about how much tax must be paid).

<sup>93</sup> In the 2009-2010 income tax year, 27 (46 percent) of the 59 applications lodged were concerned with income tax (other than tax schemes) followed by FBT (14 applications, 24 percent): AAT, above n 58, 127-128 (Table A3.1).

<sup>94</sup> Using a cross rate A\$1 = NZ\$1.312, MSN, above n 89. From 1 November 2010, the fee cannot be waived in the case of financial hardship: AAT, *Changes to AAT fees* <[www.aat.gov.au](http://www.aat.gov.au)>.

<sup>95</sup> See further AAT, *Practice Direction relating to Section 37 of the Administrative Appeals Tribunal Act 1976* <<http://www.aat.gov.au/PracticeDirectionsAndGuides/Section37PracticeDirection30April2007.htm>>.

<sup>96</sup> AAT, *The Small Taxation Claims Tribunal 3*, <<http://www.aat.gov.au/ApplyingToTheAAT/SmallTaxationClaims.htm>>.



Normally only one conference is held. However, a second conference may take place if the Tribunal member or Conference Registrar conducting the first conference believes there is a real prospect of resolution if a second conference occurs and/or special circumstances exist. Any second conference will take place within 4 weeks of the first conference. Alternatively, another type of dispute resolution process may be held, such as mediation,<sup>97</sup> conciliation case appraisal or neutral evaluation.<sup>98</sup> A consideration of alternative dispute resolution (ADR) for small tax disputes, such as mediation and arbitration, is beyond the scope of this paper.

The AAT Annual Report observes that in the 2009-2010 year 95 percent of applications were finalised at the conference stage without a hearing.<sup>99</sup> This compares favourably with 84 percent and 72 percent in the 2008-2009 and 2007-2008 years, respectively.

If the conference is unsuccessful in resolving the dispute, the matter will be heard by the STCT by way of a public, but informal, hearing (unless the taxpayer satisfies the SCTC that the hearing should be in private). In certain circumstances, some of the information might also be made public. The AAT can order that information be kept confidential if there is good reason to do so.

Certain procedures may be adopted by the STCT at the hearing to simplify proceedings and reduce the need to call witnesses at a hearing.<sup>100</sup> At the discretion of the presiding member (and the other party's consent), part of any hearing may be conducted either by telephone or video link. Decisions of the STCT are delivered orally at the end of the hearing. Written reasons will be provided if either party so requests.<sup>101</sup> The taxpayer only bears their own costs – not those of the ATO - if their appeal is unsuccessful.

In the 2009-2010 year the AAT Annual Report indicates that 59 applications were lodged with the STCT (compared with 97 and 94 applications in the 2007-2008 and

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<sup>97</sup> With respect to mediation, the Small Taxation Claims Tribunal Practice Direction states: 'If the application does not resolve at, or shortly after the first conference, a party may [within 2 weeks of the first conference] request that mediation take place. The Tribunal may also recommend to the parties that mediation take place.': AAT, above n 87, 2. The consent of both parties is required before mediation can occur.

<sup>98</sup> AAT, above n 96, 3. For information concerning alternative dispute resolution see AAT, *Alternative Dispute Resolution* <<http://www.aat.gov.au/ApplyingToTheAAT/AlternativeDisputeResolution.htm>>.

<sup>99</sup> AAT, above n 58, 133 (Table A3.4).

<sup>100</sup> The Practice Direction advises one of the following procedures may be adopted at the hearing if it is appropriate in the circumstances of the particular application: (i) 'Statement of Agreed Facts - Where the application involves a question of law and/or statutory interpretation and the applicant is represented, the Tribunal may require the parties to lodge a statement of agreed facts signed by both parties 7 days prior to the hearing. At the hearing, any oral evidence or cross-examination will only be about the facts in dispute'; **or** (ii) 'Statement of Facts Not in Dispute - Where the applicant is not represented and there is no substantial dispute as to the facts, the Tribunal may require the ATO to prepare a document which sets out all the facts which the ATO does not dispute. The ATO would be required to lodge the document with the Tribunal and give it to the applicant 7 days prior to any hearing'; **or** (iii) 'Witness Statements - Where there is no substantial agreement as to the facts, the Tribunal may require the parties to prepare written witness statements. The parties would be required to lodge the statements with the Tribunal and give them to the other party 7 days prior to any hearing. The statement will be treated as the evidence of the witness and cross-examination will only be about the facts in dispute.': AAT, above n 87, 2.

<sup>101</sup> *Administrative Appeals Tribunal Act 1976* (Cth), s 43(2A).

2007-2008 years, respectively).<sup>102</sup> The STCT finalised 98 applications in 2009-2010 (83 and 115 in the two preceding periods) with 31 applications shown as 'current' at the end of the reporting period (compared with 68 and 55 in the 2008-2009 and 2007-2008 periods, respectively).<sup>103</sup>

The taxpayer or Commissioner of Taxation may appeal to the Federal Court against a STCT decision on a point of law. According to the AAT Annual Report one appeal was lodged with the Federal Court from a decision of the STCT. This compared with two in the prior year and no appeals in the 2007-2008 year.<sup>104</sup> These statistics may add weight to the author's contention that appeal rights are not an important issue for taxpayers with small tax disputes. With respect to outcomes of appeals heard, in 2009-2010 the only appeal reported was discontinued.<sup>105</sup> In the preceding year the only appeal heard was dismissed. No outcomes of appeals were reported for 2007-2008.

The AAT states that the STCT aims to finalise applications within 12 weeks of lodgment.<sup>106</sup> In the 2009-2010 reporting year the Annual Report notes that 22 percent of applications met this standard.<sup>107</sup> This was an increase from 18 percent (2008-2009) and 17 percent (2007-2008), although well short of the desired standard.<sup>108</sup> The Annual Report tellingly observes that:

It is the Tribunal's experience that applications dealt with in the Small Taxation Claims Tribunal cannot necessarily be completed faster than other types of taxation reviews. Although the amount of tax in dispute may not be large, the issues in dispute can be complex and the parties may require additional time to gather relevant material.<sup>109</sup>

## **C The United Kingdom and the First-tier Tribunal**

### *1 Introduction*

As part of a programme of tribunal reform the *Tribunals, Courts and Enforcement Act 2007* (UK) created a new tribunal system to replace some 70 tribunals dealing with a wide range of matters.<sup>110</sup> The tribunals are independent, judicial bodies. Cases may be heard by either legally qualified members, non-legally qualified members or a combination of the two. The overriding objective of the tribunals is to deal with cases

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<sup>102</sup> AAT, above n 58, 23 (Chart 3.6). The Annual Report acknowledges that lodgements were significantly lower in the 2009-2010 year with a marked decline in applications concerning release from taxation liabilities: at 22. The number of applications lodged in the STCT compares with 994 lodgements in the Taxation Appeals Division, or 6 percent of such lodgements: at 21 (Chart 3.2).

<sup>103</sup> Ibid 23 (Chart 3.6).

<sup>104</sup> Ibid 137 (Table A3.9).

<sup>105</sup> Ibid 139 (Table A3.11).

<sup>106</sup> AAT, above n 96, 3.

<sup>107</sup> AAT, above n 58, 26 (Table 3.10).

<sup>108</sup> Ibid 26 (Table 3.10).

<sup>109</sup> Ibid.

<sup>110</sup> HMRC, *ARTG1010 - Introduction: Background*

<<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG1010.htm>>. For an overview of the changes see Robert Carnwath, *The Senior President of Tribunals' Annual Report: Tribunals Transformed* (2010) <[www.tribunals.gov.uk](http://www.tribunals.gov.uk)>.

fairly and justly.<sup>111</sup> The administration of tribunals, including making arrangements for hearings, is carried out by the Tribunals Service which is part of the UK Ministry of Justice.

The *Tribunals, Courts and Enforcement Act 2007* (UK) introduced the framework for a new two-tier tribunal system - the First-tier Tribunal and the Upper Tribunal - with specialist Chambers handling similar types of appeal. From 1 April 2009 the vast majority of tax appeals are heard by the First-tier Tribunal (also known as the Tax Chamber) in the first instance.<sup>112</sup> A small number of appeals (i.e. cases coming within the Complex category) may be transferred to the Upper Tribunal (also known as the Tax and Chancery Chamber).<sup>113</sup> The tribunal system brings together matters previously heard by the General Commissioners<sup>114</sup> and Special Commissioners,<sup>115</sup> the VAT & Duties Tribunal<sup>116</sup> and the Tribunal constituted under s 706 of the *Income and Corporation Taxes Act 1988* (UK).<sup>117</sup>

Decisions of the First-tier Tribunal may be appealed to the Upper Tribunal<sup>118</sup> on a point of law if the First-tier Tribunal or Upper Tribunal gives permission (or leave, in Northern Ireland).<sup>119</sup>

## 2 *The review process*<sup>120</sup>

From 1 April 2009, to coincide with the new tribunal system, Her Majesty's Revenue and Customs (HMRC) introduced a new optional statutory review process for

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<sup>111</sup> HMRC, *ARTG8020 - First-tier and Upper Tribunals: Introduction: Tribunals*, <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8020.htm>>.

<sup>112</sup> Tax credit appeals are dealt with in the Social Entitlement Chamber.

<sup>113</sup> For such cases to be transferred both the parties must agree and the consent of the President of the Tax Chamber and of the President of the Finance and Tax Chamber (in the Upper Tribunal) is also required: *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009*, r 28.

<sup>114</sup> The General Commissioners heard the most straightforward appeals against HMRC decisions in relation to direct taxation.

<sup>115</sup> The Special Commissioners were all legally qualified and heard more complex direct taxation cases. There were 25 such Commissioners. Decisions of the Special Commissioners are not binding on the First-tier Tribunal: see for example *Frossell* [2010] TC 00382.

<sup>116</sup> This Tribunal dealt with appeals against decisions of HMRC in relation to indirect taxation, largely VAT, excise and customs duties.

<sup>117</sup> This Tribunal heard matters concerning the anti-avoidance provisions of s 706.

<sup>118</sup> In early 2010 there were 50 tax appeals to be heard by the Upper Tribunal with a small number of judicial reviews pending: Carnwath, above n 110, 45.

<sup>119</sup> The Upper Tribunal is a superior court of record and therefore has the same status as the High Court. It replaced the High Court in England and Wales for tax appeals and will also consider appeals in Scotland and Northern Ireland. Its decisions are binding on lower tribunals and authoritative on the interpretation of the law. Appeals against the decisions of the Upper Tribunal are made to the relevant appellate court on a point of law and with permission (or leave, in Northern Ireland) from the Upper Tribunal or relevant appellate court. Either the taxpayer or HMRC may appeal decisions of the Upper Tribunal to the relevant appellate court (Court of Appeal, or Court of Appeal in Northern Ireland, or the Court of Session in Scotland) in certain circumstances.

<sup>120</sup> See HMRC, *ARTG2010 - Reviews and appeals overview: Process for direct taxes* <<http://www.hmrc.gov.uk/manuals/artgmanual/artg2010.htm>>. Direct taxes include those listed in HMRC, *ARTG1060 - Introduction: Guidance - direct taxes* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG1060.htm>>. For indirect taxes see HMRC, *ARTG2020 - Reviews and appeals overview: Process for indirect taxes* <<http://www.hmrc.gov.uk/manuals/artgmanual/artg2020.htm>>.

appealable tax decisions, with the aim of resolving disputes more quickly and cost-effectively.<sup>121</sup> Taxpayers who disagree with a direct tax decision of the HMRC have 30 days from the date of the decision to appeal in writing to HMRC against it (and include an explanation of what they disagree with and their reasons). This may lead to further discussions between the taxpayer and HMRC officials - usually the HMRC officer who is responsible for the decision - with the aim of resolving the dispute. According to HMRC most disputes are resolved in this way.<sup>122</sup>

If discussions between the taxpayer and HMRC do not resolve the matter or if discussions are not appropriate or possible, HMRC may offer a review. The taxpayer has 30 days from the date of the review offer to accept it or to send the appeal to the tribunal. If the taxpayer takes no action the dispute is treated as settled by agreement.

In addition, at any time after the taxpayer has sent their appeal to HMRC, they may either request a review by HMRC or notify the appeal to the First-tier Tribunal (by a notice of appeal).<sup>123</sup> However, once the taxpayer has accepted a review offer (or asked for a review), they may only notify the appeal to the tribunal after either they have been advised by way of a review letter of the outcome by HMRC or the 45 day (or other agreed) review period has expired.

The processes for disputing an indirect tax decision of the HMRC are similar to direct tax decisions.<sup>124</sup> If the taxpayer wishes to dispute an indirect tax decision, they can either accept HMRC's offer of a review or appeal to the tribunal within 30 days of the HMRC decision letter.<sup>125</sup>

If a taxpayer wants their case heard by the tribunal and it is a direct tax case they must first have appealed to HMRC, but in a crucial change from the previous process, can then appeal immediately to the tribunal. "This puts the taxpayer in control of his own appeal and he can decide whether (and when) he wants to take his appeal to the tribunal so that the judicial process can commence."<sup>126</sup> Similarly, HMRC cannot request a direct tax appeal to be considered by the tribunal; rather, to progress the case HMRC must offer the taxpayer a review. Appeals against indirect decisions must (as under the previous system) still be made directly to the tribunal.

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<sup>121</sup> The review existed previously for some indirect taxes and, informally, for VAT purposes.

<sup>122</sup> HMRC, above n 120 (*ARTG2010*). According to HMRC, in the 12 months from 1 April 2009, 30,530 customers asked for a review by HMRC: HMRC, *HMRC's review process - the first twelve months* <<http://www.hmrc.gov.uk/complaints-appeals/review-process.htm>>. The majority (81 percent) were unrepresented taxpayers. Approximately 75 percent of the reviews concerned penalties such as for filing their tax return late.

<sup>123</sup> A seven-page Notice of Appeal form can be downloaded from the Tribunals Service website for this purpose, see <[http://www.tribunals.gov.uk/tax/Documents/NoticeofAppeal\\_Jun10.pdf](http://www.tribunals.gov.uk/tax/Documents/NoticeofAppeal_Jun10.pdf)>.

<sup>124</sup> HMRC, *How to appeal against an HMRC decision - indirect tax* <<http://www.hmrc.gov.uk/complaints-appeals/how-to-appeal/indirect-tax.htm>>.

<sup>125</sup> *Taxes Management Act 1970* (UK), s 49F. The HMRC notes that even close to the tribunal hearing it may be appropriate to settle the case by agreement, for example if new information is provided by the taxpayer: HMRC, *ARTG8440 - First-tier and Upper Tribunals: Preparing for tribunal: Communication with the customer* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8440.htm>>.

<sup>126</sup> Penny Hamilton, *Basically the same?* 1, <<http://www.taxation.co.uk/taxation/articles/2010/07/14/20702/basically-same>>.

The review is carried out by an HMRC officer who has not previously been involved in the original decision. Taxpayers can provide additional information about their case during the review. The review conclusion letter must set out HMRC's reasoning and conclusions on the matters subject to the review.<sup>127</sup>

### 3 *The First-tier Tribunal*

#### (a) *Introduction*

In most cases the taxpayer's appeal will be considered by the First-tier Tribunal. In certain circumstances, the decision of the First-tier Tribunal can be appealed to the Upper Tribunal. The Upper Tribunal may also, in cases falling within the Complex category and with the agreement of the parties and the consent of the First-tier Tribunal and Upper Tribunal,<sup>128</sup> hear cases in the first instance, without the case being heard by the First-tier Tribunal.<sup>129</sup>

There is no fee charged for filing an appeal with the First-tier Tribunal. It is intended that the tribunal system is accessible<sup>130</sup> (hence there is a network of hearing centres across the UK).

In order to manage the cases before them the tribunals have published procedural rules. The relevant rules for the Tax Chamber are contained in *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK).<sup>131</sup> The overriding objective of *The*

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<sup>127</sup> Statistics show for the period 1 April to 31 December 2009, in approximately 53 percent of cases, HMRC's original decision was cancelled, indicating that internal reviews may be a useful tool for taxpayers wanting to avoid litigation: Maryanna Sharrock and Catherine Robinson, 'Comment: Property & Tax – how to get the best from Tax Tribunals' (August 2010) *Hedgeweek* <<http://www.hedgeweek.com>>. Bullock observes that the HMRC review works well where one of the parties 'clearly "got it wrong" or where the dispute is a question of judgment (eg, the appropriate level of a penalty) where a slightly moderated position by HMRC can result in a taxpayer accepting the revised position and consequently withdrawing the appeal': James Bullock: 'Tax disputes: the way forward' (2 August 2010) *Tax Journal* 2, <<http://www.taxjournal.com/tj/articles/tax-disputes-way-forward>>. However, he comments, 'where positions are more entrenched – or quite simply the substance of the appeal is more of a "grey area", it is difficult to see how such a Review is likely to overturn a position which has already been the subject of substantive enquiries, correspondence or even negotiations.': *ibid*, 3. The CCH (UK) Tax Reporter records similar concerns of certain commentators: 'the reviews will not allow the reviewers to step outside established HMRC policy, even if it is widely thought that that policy would be overturned by a Tribunal.': CCH Online, '[190-390] Scope of statutory reviews' *Tax Reporter*, <[http://www.cchinformation.com/CCH/Gateway.dll?f=templates\\$fn=default.htm\\$3.0&s=6&GLOBAL=G&G\\_ZZFILE1=&G\\_NXTSITE=CCH&G\\_VID=livecch:10.1048/enu&isclient=&G\\_TOC\\_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G\\_universalId=UniCanterbury&G\\_oVid=LiveCCH%3A10.1048%2Fenu](http://www.cchinformation.com/CCH/Gateway.dll?f=templates$fn=default.htm$3.0&s=6&GLOBAL=G&G_ZZFILE1=&G_NXTSITE=CCH&G_VID=livecch:10.1048/enu&isclient=&G_TOC_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G_universalId=UniCanterbury&G_oVid=LiveCCH%3A10.1048%2Fenu)>.

<sup>128</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), rr 23(5)(b) and 28(1).

<sup>129</sup> This route may be chosen where a case is likely to be litigated to the (UK) Court of Appeal (and beyond).

<sup>130</sup> *Tribunals, Courts and Enforcement Act 2007* (UK), s 22(4). At the beginning of 2009, and before the start of the new tax tribunals and HMRC processes, there were a number of outstanding tax cases many of which went back ten years: Carnwath, above n 110, 52.

<sup>131</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK) are divided into four parts. Part 1 provides some introductory rules, including the concept of the 'overriding objective'. Part 2 provides the general rules concerning the handling of cases before the Tribunal. Part 3 contains the rules that deal with the actual handling of cases by the Tribunal. Part 4 deals with the procedures that follow the issue of a decision by the Tribunal.



*Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK) is to enable the First-tier Tribunal to deal with cases 'fairly and justly'.<sup>132</sup> This includes:

- a) dealing with the case in ways which are proportionate to the importance of the case, the complexity of the issues, the anticipated costs and the resources of the parties;
- b) avoiding unnecessary formality and seeking flexibility in the proceedings ...
- c) avoiding delay, so far as compatible with proper consideration of the issues.<sup>133</sup>

This tribunal has a wide power under *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK) to 'regulate its own procedure',<sup>134</sup> bearing in mind the injunction for 'avoiding unnecessary formality and seeking flexibility in the proceedings.'<sup>135</sup> The First-tier Tribunal has extensive case management powers, including deciding the form of any hearing and the category of a case.<sup>136</sup> It may admit evidence whether or not it would be admissible in a civil trial in the UK.<sup>137</sup> The First-tier Tribunal also has the authority to suggest to the parties to the dispute that they consider ADR and arbitration.<sup>138</sup>

All First-tier Tribunal cases are heard by legally-qualified Tribunal judges and suitably qualified Tribunal members. Taxpayers can be represented by an advisor at the hearing or, if they are unrepresented, may take along a friend for support. In most cases HMRC's case will be presented by a member of HMRC staff. In more complicated direct tax cases, and in the majority of indirect tax cases, HMRC's case will be presented by counsel.

*(b) The four categories of cases*

When the tribunal receives a notice of appeal<sup>139</sup> it will, in line with *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), allocate the case to one of the following categories:

- Default Paper cases, which are usually disposed of without a hearing;
- Basic cases, which will usually be disposed of after an informal hearing and with minimal exchange of documents before the hearing;

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<sup>132</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 2(1).

<sup>133</sup> Ibid r 2(2).

<sup>134</sup> Ibid r 5(1).

<sup>135</sup> Ibid r 2(2)(b).

<sup>136</sup> Ibid r 5(1)-(3). See HMRC, *ARTG8500 - First-tier and Upper Tribunals: Preparing for tribunal: Case management powers* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8500.htm>>.

<sup>137</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 15(2)(2). CCH observes: 'This means, for example, that witnesses of fact will be able to give opinion evidence (i.e. evidence that should ordinarily come from expert witnesses). It is suggested, however, that the Tribunal would not necessarily give evidence admissible under this rule its full weight.': CCH Online, '[190-540] Rule 15 - evidence and submissions' *Tax Reporter* <[http://www.cchinformation.com/CCH/Gateway.dll?f=templates\\$fn=default.htm\\$3.0&s=6&GLOBAL=G&G\\_ZZFILE1=&G\\_NXTSITE=CCH&G\\_VID=livecch:10.1048/enu&isclint=&G\\_TOC\\_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G\\_universalId=UniCanterbury&G\\_oVid=LiveCCH%3A10.1048%2FEnu](http://www.cchinformation.com/CCH/Gateway.dll?f=templates$fn=default.htm$3.0&s=6&GLOBAL=G&G_ZZFILE1=&G_NXTSITE=CCH&G_VID=livecch:10.1048/enu&isclint=&G_TOC_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G_universalId=UniCanterbury&G_oVid=LiveCCH%3A10.1048%2FEnu)>.

<sup>138</sup> Ibid r 3(1).

<sup>139</sup> The notice of appeal must include: details of the decision appealed against, a copy of the decision appealed against, a copy of any reasons given for the decision, grounds of appeal, the result the taxpayer is seeking; the taxpayer's name and address (and that of their agent if relevant): *ibid*, r 20(2), (3).



- Standard cases, which will usually be subject to more detailed case management and be disposed of after a hearing (and have not been classified under one of the other three case categories); and
- Complex cases. Cases are categorised as complex if the tribunal considers the case will:<sup>140</sup> (a) require lengthy or complex evidence or a lengthy hearing; (b) involve a complex or important principle or issue; or (c) involve a large financial sum.<sup>141</sup>

The tribunal may, at any time, decide to allocate the case to a different category.<sup>142</sup> In addition, while – somewhat surprisingly – the standard notice of appeal form does not provide for the appellant to indicate to which category the appeal should be allocated, HMRC or the taxpayer can apply to the tribunal for the case to be allocated to a different category.

While, as noted, Basic, Standard and Complex cases are normally decided at a hearing, both parties may consent to the matter being decided on the basis of the papers alone.<sup>143</sup>

*(i) Default Paper cases*

Under this category the tribunal hears appeals against:

- SA (self-assessment) and CTSA (corporation tax self-assessment) fixed filing penalties;
- Employer end of year late return penalties;
- Construction industry late return penalties;
- Class 2 NIC (National Insurance Contributions) late notification penalties
- Income tax surcharges; and
- Applications for penalties for failure to make a return (*Taxes Management Act 1970* (UK), s 93(3)).<sup>144</sup>

Default Paper cases are decided on the basis of paper submissions alone (notice of appeal, HMRC statement of case and other relevant documents), although either the taxpayer or HMRC (on rare occasions)<sup>145</sup> may request the case be decided at a hearing with the parties present. If such a request is made the tribunal must hold a hearing to decide the issue - in which case, the appropriate rules and procedures for the Basic category will apply. The tribunal may also, on its own initiative, direct that a hearing takes place.<sup>146</sup>

The HMRC is normally required to send a statement of case to the tribunal and a copy to the taxpayer within 42 days after the Tribunals Service sent it the taxpayer's notice of appeal. The statement of case must outline the legislative provision under which the

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<sup>140</sup> Ibid r 23(4).

<sup>141</sup> Ibid r 23.

<sup>142</sup> Ibid r 23(3).

<sup>143</sup> Ibid r 29(1).

<sup>144</sup> HMRC, ARTG8350 - *First-tier and Upper Tribunals: Preparing for tribunal: Categories of tribunal case* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8350.htm#IDA2WHCH>>.

<sup>145</sup> HMRC, ARTG8370 - *First-tier and Upper Tribunals: Preparing for tribunal: Default Paper cases* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8370.htm>>.

<sup>146</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 26.

original decision was made, and HMRC's position on the issues in dispute (including copies of documents where appropriate).<sup>147</sup>

The taxpayer may send to the tribunal a response to HMRC's statement of case - with arguments outlining the taxpayer's response to it and any other relevant information and documents) - within 30 days (unless an extension is granted) of the date HMRC sent a copy of its statement of case to the taxpayer. The response may also include a request for the case to be dealt with at a hearing. The 30-day timeframe has been subject to criticism as 'HMRC communications regularly arrive a week or so after the day which appears on their covering letter. It would have been better if the rule operated by reference to the date that the appellant received the respondent's statement of case.'<sup>148</sup>

Neither HMRC nor the taxpayer can send any further evidence or arguments after this point (unless the tribunal gives permission for them to do so). In most cases, the taxpayer will receive a decision in writing as soon as possible - within 28 days - unless the appeal is going to a hearing.

This category is essentially concerned with penalties imposed on taxpayers rather than substantive legal issues. Taxpayers have welcomed the Default Paper category as it offers a chance to have a dispute decided by the tribunal without a hearing.<sup>149</sup>

*(ii) Basic cases*

The following types of appeal or application may be heard in the Basic category provided the case does not fall within the Default Paper category:

- Penalties for late filing and late payment, including daily penalties;
- Penalties for incorrect returns, except appeals against penalties for deliberate action whether concealed or not;
- Cases where an appeal is also brought against the assessment of the tax to which the return relates, and indirect tax cases;
- Penalties in indirect taxes where the customer is appealing on the basis of reasonable excuse;
- Decisions on construction industry scheme gross payment status Regulations 2005; and
- Information notices.<sup>150</sup>

In addition, the following applications also come within the Basic case category, applications for:

- Permission to make a late appeal;
- Postponement of the payment of tax pending resolution of an appeal; and

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<sup>147</sup> Ibid r 25(2).

<sup>148</sup> CCC Online, '[190-610] Rule 26 - Default paper cases' *Tax Reporter*  
<[http://www.cchinformation.com/CCH/Gateway.dll?f=templates\\$fn=default.htm\\$3.0&s=6&GLOBAL=G&G\\_ZZFILE1=&G\\_NXTSITE=CCH&G\\_VID=livecch:10.1048/enu&isclient=&G\\_TOC\\_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G\\_universalId=UniCanterbury&G\\_oVid=LiveCCH%3A10.1048%2FEnu](http://www.cchinformation.com/CCH/Gateway.dll?f=templates$fn=default.htm$3.0&s=6&GLOBAL=G&G_ZZFILE1=&G_NXTSITE=CCH&G_VID=livecch:10.1048/enu&isclient=&G_TOC_TEMPLATE=/CCH/Gateway.dll%3F%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G_universalId=UniCanterbury&G_oVid=LiveCCH%3A10.1048%2FEnu)>.

<sup>149</sup> Hamilton, above n 126, 5.

<sup>150</sup> HMRC, above n 144.

- A direction that HMRC close an enquiry (e.g. applications under s 28A(4) and para 7(5) Schedule 1A *Taxes Management Act 1970* (UK) and para 33 Schedule 18 *Finance Act 1998* (UK)).<sup>151</sup>

In most cases after the notice of appeal<sup>152</sup> has been filed by the taxpayer with the tribunal (and HMRC is duly notified) the case will proceed directly to a hearing. There is no requirement for HMRC to provide a statement of case,<sup>153</sup> however, the tribunal can decide to request further information from either party. However, if HMRC intends to raise any new grounds at the hearing they must advise the taxpayer 'as soon as is reasonably practicable'<sup>154</sup> after becoming aware of the grounds and in enough detail for the customer to respond to those grounds at the hearing. Hamilton observes:

The words 'reasonably practicable' are hardly precise and an appellant faced with additional grounds at the last minute will have to rely on the wide discretion of the tribunal to ensure that the appeal is dealt with 'fairly and justly' in accordance with the overriding objective [of *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 2)].<sup>155</sup>

The parties are expected to attend the hearing and to present their cases (including presentation of documents and calling witnesses). The case could be heard by up to three members, each of whom is either a judge or a member (who may be legally qualified). The hearing is conducted in an informal manner. The president of the First-tier Tribunal, Sir Stephen Oliver has stressed that 'the "turn up and talk" approach of the General Commissioners [is] encouraged'<sup>156</sup> in Basic cases. The tribunal usually gives its decision at the end of the hearing. The decision will be confirmed in writing, with brief reasons, within 28 days.

The tribunal may make any directions it thinks are appropriate to fairly dispose of a case, for example in some complex cases such as construction industry scheme gross status appeals which may require more intensive procedures than provided for in the Basic category.<sup>157</sup> The brief discussion of the UK dispute processes in the Issues Paper focuses on the Default Paper and Basic categories of cases.

*(iii) Standard cases*<sup>158</sup>

Cases not categorised as Default Paper, Basic or Complex will be categorised as Standard cases by the tribunal. Standard cases are heard by a judge sitting alone or with one or other judges or members (who may be legally qualified).

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<sup>151</sup> Ibid.

<sup>152</sup> Overall, compared with notices of appeal for Standard and Complex cases, notices of appeal for Basic cases may be brief and undetailed.

<sup>153</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 24(2).

<sup>154</sup> Ibid r 24(4)(a).

<sup>155</sup> Hamilton, above n 126, 4.

<sup>156</sup> Ibid 5.

<sup>157</sup> HMRC, above n 144.

<sup>158</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 23(2)(c).

*(iv) Complex cases*

As outlined, cases are categorised as Complex:

- that require lengthy or complex evidence or a lengthy hearing; or
- involving a complex or important principle or issue; or
- involving a large financial sum.<sup>159</sup>

Commentators have expressed concern that there is no official guidance on the application of these criteria, some of which are vague.<sup>160</sup> The Upper Tribunal in *Capital Air Services Ltd v HMRC*<sup>161</sup> made it clear that these criteria are to be determined by the First-tier Tribunal.<sup>162</sup>

For Standard and Complex cases, within 60 days of the tribunal sending the taxpayer's notice of appeal to HMRC, the revenue authority must send a statement of case to the tribunal (and a copy to the taxpayer). The statement of case will contain similar information to that described above for the Default Paper category, though the facts and issues will obviously be more complex.

The parties have 42 days from the date the statement of case is sent to provide the tribunal and other party a list of documents they intend to rely upon.<sup>163</sup> The tribunal may make any direction at this time as to what is required from the parties. The hearing will be more formal than for Basic cases. The taxpayer will receive a decision in writing within 28 days of the hearing.

*(c) Hearings, decisions and costs*

The tribunal may give its decision orally at a hearing.<sup>164</sup> Whether there has been a hearing or not the tribunal must provide a decision notice to the parties within 28 days of making the decision (or as soon as practicable thereafter).<sup>165</sup> The decision notice must state the Tribunal's decision and, unless the parties agree it is unnecessary, include a summary of the findings of fact and the reasons for the decision, or be accompanied by full written findings of fact and reasons for the decision.<sup>166</sup> A party

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<sup>159</sup> Ibid r 23(4).

<sup>160</sup> Matthew Hodkin and David Ward, 'Capital Air Services and 'Complex' cases' (8 November 2010) *Tax Journal* 2, <<http://www.taxjournal.com/tj/print/23874>>.

<sup>161</sup> *Capital Air Services Ltd v HMRC* [2010] UKUT 373 (CTC).

<sup>162</sup> In this case the Upper Tribunal was asked to consider these criteria after the First-tier Tribunal held the appellant's case did not fall within the criteria and could not be allocated as a Complex case. The Upper Tribunal stated it was for the First-tier Tribunal to assess whether any of the criteria were satisfied – a judgment that would differ between judges – and accordingly there was not a single 'right' answer that could be ascertained objectively as a matter of law: *Capital Air Services Ltd v HMRC* [2010] UKUT 373 (CTC) [23]. However there were limits outside of which the tribunal could not stray. 'It would be perverse to say that a hearing of 1/2 day could ever be lengthy or that a 3 month case was not lengthy. It would be perverse to say a case involving tax of £1,000 involved a large financial sum or that a case involving tax of £100 million did not do so.': *Capital Air Services Ltd v HMRC* [2010] UKUT 373 (CTC) [24].

<sup>163</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 27.

<sup>164</sup> Ibid r 35(1).

<sup>165</sup> Ibid r 35(2).

<sup>166</sup> Ibid r 35(3).

cannot appeal a decision of the First-tier Tribunal without a full statement of reasons for the decision.

All hearings will be held in public except where the tribunal gives a direction that the hearing, or part of it, is to be held in private. The tribunal can restrict access to the hearing if it thinks it is justified.<sup>167</sup> The tribunal may publish a decision or the reasons for a decision (subject to ensuring any published report does not disclose information that was referred to only in the part of the hearing held in private).

Costs (in Scotland, expenses) may be awarded by the tribunal in Complex cases -except where the customer has written to the tribunal opting out of the costs regime.<sup>168</sup> The tribunal may make an order on an application or on its own initiative.<sup>169</sup> While the tribunal has no general power to award costs or expenses (as appropriate) to either party in Default Paper, Basic or Standard category cases, it can make a wasted costs order,<sup>170</sup> or an order for costs against a party who has 'acted unreasonably in bringing, defending or conducting the proceedings.'<sup>171</sup> The tribunal cannot make an order relating to costs against either the taxpayer or HMRC without taking into account their financial means (if an individual), and giving them an opportunity to make representations.<sup>172</sup>

At this stage, due to the comparative short period the First-tier Tribunal has been hearing tax appeals, it is premature to assess how successful the process is. Due to a concerted effort to clear outstanding disputes before the commencement of the new

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<sup>167</sup> For example, where it is in the interests of public order or national security or to maintain the confidentiality of sensitive information.

<sup>168</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 23(5)(a).

<sup>169</sup> The matter of costs attracted significant comment from stakeholders during the initial consultation on proposal for a new Tax Chamber: Gemma Young, 'Tax Appeals Modernisation' (6 October 2008) *Tax Journal* 2, <<http://www.taxjournal.com/tj/print/20663>>. There were concerns that the prospect of paying HMRC's costs should not deter taxpayers from pursuing an appeal. Similarly, Young comments that there was also concern that taxpayers may be discouraged by the inability to recover their own costs from HMRC, especially in terms of seeking legal representation: *ibid*, 2.

<sup>170</sup> Wasted costs are those costs incurred by a party either: as a result of any improper, unreasonable or negligent act or omission on the part of any legal or other representative; or before such conduct but, in the light of which, the Tribunal considers it unreasonable to expect that party to pay: *Tribunals, Courts and Enforcement Act 2007* (UK), s 29(4)-(6).

<sup>171</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 10(1)(a),(b). 'This is a relaxation of the rule that applied in cases before the special commissioners. There, the conduct had to be "wholly unreasonable" before a costs award could be made (the *Special Commissioners (Jurisdiction and procedure) Regulations 1994* (SI 1994/1811), reg. 21)... Furthermore, the rules have diverged from the wording of the former regulations in another, slightly more subtle, way. Previously, costs were potentially available only if the unreasonable conduct was "in connection" with the hearing. Under the new rules, the conduct can relate to the actual decision to bring (or defend) the proceedings as well as in relation to the actual conduct of the proceedings.' : CCH Online, '[190-515] Rule 10 - costs awards', *Tax Reporter*, <[http://www.cchinformation.com/CCH/Gateway.dll?f=templates\\$fn=default.htm\\$3.0&s=6&GLOBAL=G & G\\_ZZFILE1=&G\\_NXTSITE=CCH&G\\_VID=livecch:10.1048/enu&isclient=&G\\_TOC\\_TEMPLATE=/CCH/Gateway.dll%3Ff%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G\\_universalId=UniCanterbury&G\\_oVid=LiveCCH%3A10.1048%2FEnu](http://www.cchinformation.com/CCH/Gateway.dll?f=templates$fn=default.htm$3.0&s=6&GLOBAL=G & G_ZZFILE1=&G_NXTSITE=CCH&G_VID=livecch:10.1048/enu&isclient=&G_TOC_TEMPLATE=/CCH/Gateway.dll%3Ff%3Dtemplates%24fn%3Dcontents-frame-js.htm%243.0&G_universalId=UniCanterbury&G_oVid=LiveCCH%3A10.1048%2FEnu)>.

<sup>172</sup> *The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009* (UK), r 10(5). See also HMRC, ARTG8660 - *First-tier and Upper Tribunals: The tribunal hearing: Tribunals right to award costs* <<http://www.hmrc.gov.uk/manuals/artgmanual/ARTG8660.htm>>. The amount of costs to be paid can be arrived at by decision of the First-tier Tribunal; by agreement between the paying and receiving persons; or by consideration of all or part of the costs incurred by the receiving person, if not agreed: *ibid* r 10(6).

HMRC processes (or cases being in the new HMRC review stage), as at early 2010 there had been less 'of the old [smaller] General Commissioner-type work' heard by the First-tier Tribunal.<sup>173</sup> However, there had been a surge of high value appeals, where the tax in dispute ranged from £1m to £1,000 million.<sup>174</sup> Bullock observes that anecdotally the First-tier Tribunal is understood to have registered approximately 10,000 appeals in its first year of operation, which represents a 50 percent reduction from appeals listed under the former regime indicating the success of the HMRC review process.<sup>175</sup> He comments that this is about 2.5 percent of all tax disputes between HMRC and taxpayers.

Sharrock and Robinson<sup>176</sup> observe that there is a potential weakness in the new system:

which, in an effort to minimise costs, encourages taxpayers to conduct their own appeals, or to use advisors who are not experienced litigators, and there may be a correlation between this and the number of cases where the Tribunal's decision is that the evidence provided does not support the taxpayer's claims.

Sharrock and Robinson<sup>177</sup> therefore recommend that taxpayers 'should consider instructing tax litigation experts at an early stage to ensure that the best case is put forward for' them. Alternatively, more guidance may be required from the First-tier Tribunal on the importance of evidence.

#### **D Canada and the Informal Procedure in the Tax Court of Canada**

The Tax Court of Canada (TCC) is a federal court established by the *Tax Court of Canada Act, S.C. 1980-81-82-83* (Can), c. 158, effective 18 July 1983. Its jurisdiction includes hearing appeals from assessments under *inter alia* the *Income Tax Act, R.S.C. 1985* (Can), c. 1, the *Excise Act, R.S.C. 1985* (Can), c. E-15, the *Employment Insurance Act, S.C. 1996* (Can), c. 23 and Canada Pension Plan.<sup>178</sup>

Before appealing to the TCC to have it resolve an income tax or Goods and Services Tax (GST) dispute, the taxpayer must first send a notice of objection to the Canada Revenue Agency (CRA). The CRA review of the objection will result in a reassessment, a confirmation or a determination. If the taxpayer is an individual or a testamentary trust the time limit for filing an objection is within:

- (i) One year of the date of the return's filing deadline; or
- (ii) 90 days of the date the CRA mailed the notice of assessment.

In every other case, the objection must be filed within 90 days of the date the notice of assessment is mailed.

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<sup>173</sup> Carnwath, above n 110, 52.

<sup>174</sup> Ibid.

<sup>175</sup> Bullock, above n 127, 2.

<sup>176</sup> Sharrock and Robinson, above n 127.

<sup>177</sup> Ibid.

<sup>178</sup> For a discussion of the TCC and its history see Wilfrid Lefebvre, 'Income Tax Litigation' (1995) 43(5) *Canadian Tax Journal* 1861 and 'Tax Court of Canada 20<sup>th</sup> Anniversary Symposium' (2005) 53(1) *Canadian Tax Journal* 135.



The CRA advises that they will review the objection and if necessary contact the taxpayer (or their advisor) to discuss the matter:

and to provide an open exchange of information, we [the CRA] can provide you with the documents relating to the issues in dispute. In addition, we inform you of any discussions we have had with assessing area representatives about your disputed assessment.<sup>179</sup>

After the facts have been considered, the Chief of Appeals, or another authorised officer in the CRA Appeals Branch, will make the final decision concerning the assessment.<sup>180</sup> The Appeals Branch is 'independent' of the auditing and assessing sections of the CRA and will take a fresh and independent view of the facts and law involved in the dispute. This function is similar in part to that undertaken by the Inland Revenue Adjudication Unit in New Zealand (see section 2 of this article).

If the CRA rejects the taxpayer's objection the taxpayer has 90 days to appeal to the TCC.<sup>181</sup> There are two procedures for appealing to the TCC: (1) the [Informal Procedure](#),<sup>182</sup> and (2) the [General Procedure](#).<sup>183</sup> The Informal Procedure is governed by provisions contained in section 18 of the *Tax Court of Canada Act, R.S.C. 1985 (Can)*, c. T-2, as amplified in *Tax Court of Canada Rules (Informal Procedure)*, *SOR/90-688b*,<sup>184</sup> promulgated effective 1 January 1991. A filing fee of C\$100 (equivalent to NZ\$130.63)<sup>185</sup> is payable by taxpayers electing the Informal Procedure.<sup>186</sup> The fee is refunded if the appeal is allowed in whole, or in part. The court may also choose to waive the fee in cases of severe financial hardship.

Taxpayers can elect to use the Informal Procedure for disputes where:

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<sup>179</sup> CRA, *Resolving Your Dispute: Objections and Appeal Rights under the Income Tax Act* (December 2009) <[www.cra.gc.ca](http://www.cra.gc.ca)>. Information made available by the CRA to the taxpayer includes: working papers and reports prepared by the auditor supporting the assessment (as well as relevant copies of legislation and cases); records of discussions between an appeals officer and an auditor concerning the assessment and information from third parties that the taxpayer has been dealing with (eg sales invoices and purchase orders): *ibid* 8-9. Certain information cannot be provided due to its sensitive nature and to maintain the integrity of the tax system including information subject to legal professional privilege and documentation related to an on-going investigation: *ibid* 9.

<sup>180</sup> The Appeals Branch of the CRA receives 45,000 – 65,000 objections relating to the various Canadian taxes: Paul Hickey, 'Appeals and Tax in Dispute' (2007) 15(1) *Canadian Tax Highlights* 2. About 92 percent are resolved administratively, with the remaining 8 percent appealed to the courts. Of the 8 percent, approximately one-third each are withdrawn by the taxpayer, settled or heard: *ibid*.

<sup>181</sup> Taxpayers can also appeal to the TCC if the CRA does not respond to their objection notice within 90 days in an income tax case or 180 days in a GST case.

<sup>182</sup> The informal procedure was instituted in *The Act to Amend the Tax Court of Canada Act and Other Acts in Consequence Thereof SC 1988*, effective 1 January 1991.

<sup>183</sup> The General Procedure is the default system of the TCC and follows formal court rules, which cover filing of an appeal, rules of evidence, examinations for discovery and production of documents: CRA, *ibid* n 179, 16.

<sup>184</sup> See <<http://www.canlii.org/en/ca/laws/regu/sor-90-688b/latest/sor-90-688b.html>>.

<sup>185</sup> Using a cross rate C\$1 = NZ\$1.30,

<[http://money.msn.co.nz/currencyconverter.aspx?cmp=gl\\_nz1\\_CurrencyCalculator&mch=sem](http://money.msn.co.nz/currencyconverter.aspx?cmp=gl_nz1_CurrencyCalculator&mch=sem)> at 5 January 2011.

<sup>186</sup> If the taxpayer misses the deadline for initiating an appeal due to exceptional circumstances beyond their control, they may apply to the TCC to extend the time limit.

- the total amount of federal tax and penalties in dispute per assessment (i.e. for each taxation year), excluding interest, is not more than C\$12,000 (equivalent to NZ\$15,682.80);<sup>187</sup>
- the disputed loss amount is not more than C\$24,000 per determination (equivalent to NZ\$31,348.80);<sup>188</sup>
- interest on federal tax and penalties is the only matter in dispute.

When the amount in dispute in an income tax case is greater than C\$12,000, the taxpayer may choose to restrict the amount under appeal to C\$12,000; otherwise the [General Procedure](#) will apply. A taxpayer disputing a loss amount can likewise restrict the claim to C\$24,000 and thus come under the Informal Procedure threshold. In the absence of an election to use the Informal Procedure the taxpayer's appeal will automatically be governed by the General Procedure.

Taxpayers can also appeal an assessment or determination concerning GST and the harmonized sales tax (HST) to the TCC under the Informal Procedure. There is no limit to the amount in dispute for GST and HST that can be heard using the Informal Procedure.

The appeal is instituted either by completing the two-page '[Notice of Appeal - Informal Procedure](#)' form,<sup>189</sup> the CRA online document-filing facility accessible through the CRA web site or by a letter (without any requirements for any special form of pleading) filed at any TCC office. In addition to being signed and dated, the notice of appeal should include: the taxpayer's personal details (name, mailing address, telephone number etc) and those of their lawyer or agent (if applicable); the taxation year(s) under appeal or the assessment number; the date of the reassessment or confirmation; the grounds for the appeal and relevant facts; a statement that they are appealing under the Informal Procedure; and, if applicable (in an income tax appeal), a statement that the taxpayer is limiting the amount of their appeal to C\$12,000 for each year under appeal.

There are strict time restrictions placed on the CRA and TCC to ensure the dispute is settled quickly.<sup>190</sup> Accordingly, upon receipt of the taxpayer's notice of appeal the TCC Registry will forward a copy to the CRA, which must reply within 60 days.<sup>191</sup> The failure to do so will result in the taxpayer's allegations of fact contained in the notice of appeal being presumed as true. No later than 180 days after the filing of the CRA's reply to the taxpayer's notice of appeal,<sup>192</sup> the TCC will schedule a hearing, advice of which will be sent to the taxpayer (or their representative) by registered mail at least 30 days before the hearing.<sup>193</sup> While an adjournment may be requested prior to the hearing date, the Court is reluctant to grant adjournments unless the parties are faced with circumstances which would not permit the hearing to proceed.

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<sup>187</sup> Using a cross rate C\$1 = NZ\$1.30, MSN, above n 185.

<sup>188</sup> Ibid.

<sup>189</sup> See Tax Court of Canada, *Notice of Appeal (Informal Procedure)* <[http://cas-ncr-nter03.cas-sati.gc.ca/portal/page/portal/tcc-cci\\_Eng/Process/Forms](http://cas-ncr-nter03.cas-sati.gc.ca/portal/page/portal/tcc-cci_Eng/Process/Forms)>.

<sup>190</sup> CRA, above n 179, 15.

<sup>191</sup> *Tax Court of Canada Act, R.S.C. 1985 (Can)*, s 18.16(1).

<sup>192</sup> Ibid s 18.17(1).

<sup>193</sup> Ibid s 18.19(1).

On the hearing day, all the parties will appear in court to present their evidence (including witnesses) and arguments before the judge. Taxpayers may represent themselves or be represented by a lawyer or an agent. The *Tax Court of Canada Act, R.S.C. 1985* (Can) makes it clear that 'the Court is not bound by any legal or technical rules of evidence in conducting a hearing'.<sup>194</sup> The parties are encouraged, throughout the process, to contact each other and discuss their positions and any tentative settlement.

The *Tax Court of Canada Act, R.S.C. 1985* (Can) provides that hearings and appeals utilising the Informal Procedure 'shall be dealt with by the Court as informally and expeditiously as the circumstances and considerations of fairness permit'.<sup>195</sup> This process 'is intended to minimize the legal steps involved in the appeal process'.<sup>196</sup>

The judge may either deliver a decision on the taxpayer's appeal at the conclusion of the hearing or (in the absence of exceptional circumstances) within 90 days after the day on which the hearing concluded.<sup>197</sup> The reasons for the judgment do not need to be in writing 'except where the Court deems it advisable in a particular case to give reasons in writing'.<sup>198</sup> The TCC will send a copy of the judge's decision to both parties.

In line with the Canadian Parliament's intention of encouraging easy access to the courts, the *Tax Court of Canada Act, R.S.C. 1985* (Can), s 18.26 provides that costs may be awarded only in favour of the taxpayer; i.e, where the judgment reduces the aggregate of all amounts in issue or the amount of interest in issue, or increases the amount of loss in issue, by more than one-half. Costs cannot be awarded in favour of the Crown. This means that the taxpayer is not exposed to paying the costs of the hearing if they are unsuccessful.

The entire process, from the date the taxpayer files the notice of appeal to the decision of the judge in a TCC Informal Procedure appeal is usually completed within 11 months (330 days).<sup>199</sup> In a study undertaken in 2006 Lamoureux concluded that 36 of the income tax cases studied (i.e. 72 percent) were processed very effectively (i.e. they were disposed of within the same year) while 14 cases (28 percent) fell short of the required standard.<sup>200</sup> Of the 14 cases, 10 had not been heard - either because they had been adjourned and rescheduled (four cases) or had yet to be scheduled (six cases) - while three cases were scheduled to be heard in the near future and one case had been heard

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<sup>194</sup> Ibid s 18.15(3).

<sup>195</sup> Ibid s 18.15(3). The case *Paynter v The Queen*, 96 DTC 6578 (FCA) is an example of the operation of these principles. In *Paynter*, the taxpayer's counsel had been replaced one month before the appeal hearing and the CRA had consented to an adjournment. However, the request for an adjournment was refused on the basis that appeals under the Informal Procedure are to be heard in a quick and orderly fashion.

<sup>196</sup> Dominique Lamoureux, 'Just a Beginning - A Caseflow Management Review of The Tax Court of Canada Income Tax Cases' (2006) *Institute for Court Management, Court Executive Development Program, Phase III Project* 16. One of the priorities of the TCC in both procedures is that the court be accessible to all Canadians - as such, the court sits in 68 Canadian cities and 'has even sat in a taxpayer's kitchen when the taxpayer could not otherwise attend the meeting.': above n 178, 138.

<sup>197</sup> *Tax Court of Canada Act, R.S.C. 1985* (Can), s 18.22(1).

<sup>198</sup> Ibid s 18.23.

<sup>199</sup> Lamoureux, above n 196, 17.

<sup>200</sup> Ibid, 19.

with the judgment reserved.<sup>201</sup> The median age for the 14 'unprocessed' cases was 19 months.<sup>202</sup>

The Auditor General of Canada observed,<sup>203</sup> with respect to the 1996-1997 reporting period, that in the Informal Procedure 31 percent of cases were withdrawn by the taxpayer or dismissed, 20 percent resulted in consent judgments, and 49 percent proceeded to trial. At the trial in the Informal Procedure, taxpayers were successful, in whole or in part, about 30 percent of the time (and 33 percent in the General Procedure).<sup>204</sup> About 40 percent (2,669) of cases heard by the TCC in the reporting period to November 2006 were heard under the Informal Procedure and involved approximately 1.4 percent of the tax in dispute.<sup>205</sup> The remaining 60 percent (3,421) of cases were heard under the General Procedure and involved around 84 percent of the tax in dispute.<sup>206</sup> This compares with earlier statistics of 70 percent of cases heard under the Informal Procedure (in the mid-1990s) and 59.5 percent (for 2003).<sup>207</sup> This (percentage) decline may be due to the fact that the C\$12,000 threshold is too low or taxpayers are preferring to have even small disputes heard under the General Procedure – for example if they are complex in nature. There has clearly been a greater growth in larger disputes, perhaps due to more targeted auditing by the CRA of tax schemes etc. The total number of cases heard under the Informal Procedure has increased from 2003 to 2006 from 1,906 (2003) to 2,669 (2006) – an increase of 40 percent.<sup>208</sup> However, in this same period, the number of cases under the General Procedure has increased 164 percent (from 1,295 to 3,421). The original target was for 70 percent of disputes to be heard under the Informal Procedure.<sup>209</sup>

Section 18.28, *Tax Court of Canada Act, R.S.C. 1985 (Can)* states that decisions in appeals involving the Informal Procedure have no precedential value.<sup>210</sup> Despite this, 'informal procedure decisions, while not technically legally precedential, often do have an influential value on other judges'.<sup>211</sup> Lefebvre observes that while the Informal

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<sup>201</sup> Ibid.

<sup>202</sup> Ibid. Lamoureux comments: 'It is well known and it has been an ongoing project in the [Tax] Court, to monitor and to improve case processing practices in order to move cases along more expeditiously through the system.': *ibid* 33.

<sup>203</sup> Office of the Auditor-General, (1998) *1998 April Report of the Auditor General of Canada* [5.47] <[http://www.oag-bvg.gc.ca/internet/English/parl\\_oag\\_199804\\_05\\_e\\_9311.html](http://www.oag-bvg.gc.ca/internet/English/parl_oag_199804_05_e_9311.html)>.

<sup>204</sup> Ibid [5.47].

<sup>205</sup> Hickey, above n 180, 2.

<sup>206</sup> Ibid.

<sup>207</sup> André Gallant, 'The Tax Court's Informal Procedure and Self-Represented Litigants: Problems and Solutions' (2005) 53(2) *Canadian Tax Journal* 333, 335.

<sup>208</sup> Hickey, above n 180, 2.

<sup>209</sup> Lefebvre, above n 178, 1877.

<sup>210</sup> Golombek cites a very practical example where this aspect of the informal procedure can work against taxpayers in general: Jamie Golombek, 'Going to Court', *Forum Magazine* (June 2005) 1, <[http://jamielogolombek.com/printfriendly.php?article\\_id=832](http://jamielogolombek.com/printfriendly.php?article_id=832)>. In September 2005, the TCC, under the informal procedure, heard the case *Krause v The Queen* [2004] TCC 594 and concluded that full-time attendance at a foreign university included full-time attendance through the internet or online, therefore meaning a student could claim tuition fees for a university outside Canada. 'Originally, this case was seen to be a positive development for many online students, who could now seek some tax relief for their tuition fees, until it was pointed out by the CRA that the case was heard under the informal procedure.': *ibid*. As such the CRA has advised the case does not affect its longstanding view: *ibid*.

<sup>211</sup> Ibid 2.

Procedure incorporates a non-judicial dispute mechanism, it is still a judicial procedure as shown by the TCC's reluctance to apply a liberal interpretation to the statutory direction in the *Tax Court of Canada Act, R.S.C. 1985 (Can)*, s 18.28, citing Bowman J in *Mourtzis v The Queen*<sup>212</sup> as an example:

I regard this section as being of very limited application. I am prepared to accept it insofar as it means nothing more than this: If I do not choose to follow the decision of one of my brethren in an informal procedure, I am not bound by the strict rules of *stare decisis*. If that section is interpreted to mean that counsel is not permitted to refer to informal procedure cases or that I am not permitted to cite them or follow them if I choose to do so, then I regard that as a most unreasonable interpretation of the Act and, indeed, I would regard it as an unwarranted attempt by Parliament to interfere with my judicial independence and with the independence of the bar in this country to refer to such authorities if they see fit to refer to them. After all, the decisions of the House of Lords are not binding on me. Does that mean they should not be referred to?

Taxpayers cannot as such appeal a decision of the TCC under the Informal Procedure but decisions can be judicially reviewed on restrictive grounds.<sup>213</sup>

The Federal Court will not engage in an examination of the evidence as such, nor substitute its appraisal of the evidence for that of the TCC.

The taxpayer must apply within 30 days of the decision to the Federal Court of Appeal to have it review the decision. The taxpayer does not need a form to file an appeal. However, the review application must be in writing and state the reasons for it and relevant facts. There are prescribed timelines for the review process.<sup>214</sup>

### ***E The jurisdictions compared***

The following table summarises key points from the survey undertaken of the small tax dispute processes in Australia, the United Kingdom and Canada.

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<sup>212</sup> *Mourtzis v The Queen* 94 DTC 1,362, 1,364 (TCC).

<sup>213</sup> Decisions of the Tax Court of Canada (Informal Procedure) can be appealed if it '(a) acted without jurisdiction, acted beyond its jurisdiction or refused to exercise its jurisdiction; (b) failed to observe a principle of natural justice, procedural fairness or other procedure that it was required by law to observe; (c) erred in law in making a decision or an order, whether or not the error appears on the face of the record; (d) based its decision or order on an erroneous finding of fact that it made in a perverse or capricious manner or without regard for the material before it; (e) acted, or failed to act, by reason of fraud or perjured evidence; or (f) acted in any other way that was contrary to law.': *Federal Courts Act, R.S. 1985 (Can)*, c. F-7, s 27(1.2), (1.3).

<sup>214</sup> CRA, above n 179.

<b>Table A: Small Tax Disputes - A Comparison</b>			
	<b>Australia</b>	<b>United Kingdom</b>	<b>Canada</b>
<b>Tribunal/ Procedure</b>	Small Tax Claims Tribunal (STCT), part of the Taxation Appeals division of the Administrative Appeals Tribunal (AAT).	First-tier Tribunal (FTT) (Tax Chamber)  'Complex' cases may be heard by Upper Chamber (Tax and Chancery Chamber).	Informal Procedure of the Tax Court of Canada (TCC).
<b>Jurisdiction</b>	Tax in dispute of less than A\$5,000.  Australian Tax Office (ATO) refusal to release taxpayer from paying tax debt.	Four categories depending on importance of the case, complexity of issues, costs and resources of the parties.  Categories of case are: 'Default Paper', 'Basic', 'Standard' and 'Complex'.	Total amount of disputed federal tax and penalties (per assessment), excluding interest, is not more than C\$12,000. Taxpayer can limit claim to C\$12,000.  Disputed loss amount not more than C\$24,000. Taxpayer can limit loss claim to C\$24,000.  Interest on federal tax and penalties is the only disputed matter.  Goods and services tax, harmonised sales tax - no monetary threshold.
<b>Initiation Process</b>	Taxpayer files 2-page application form to AAT seeking review of ATO decision.	Taxpayer files 7-page notice of appeal form to FTT before or after HMRC review.	Taxpayer files 2-page notice of appeal form to TCC if internal review of earlier notice of objection unsuccessful.



<p><b>Filing Fee</b></p>	<p>A\$77 non-refundable fee.</p>	<p>No filing fee.</p>	<p>C\$100 fee, refundable if taxpayer successful (in whole or in part).  Waived on hardship grounds.</p>
<p><b>Tax Dispute Resolution Process</b></p>	<p>Pre-trial conference before member of AAT to discuss issues, facts etc, aimed at resolving case. May be second conference or alternate dispute procedures (eg mediation) prior to STCT hearing.  Proceed to STCT hearing.</p>	<p>Depends on category of case:</p> <ul style="list-style-type: none"> <li>• 'Default Paper' – decided on paper submissions alone, normally no hearing;</li> <li>• 'Basic' informal hearing with all parties present, minimal exchange of documents, 'turn up and talk' approach;</li> <li>• 'Standard' and 'Complex' cases – more detailed case management, formal hearing.</li> </ul> <p>FTT has wide powers to regulate its procedures.</p>	<p>Appeal dealt with by the TCC as informally and expeditiously as the circumstances and considerations of fairness permit.</p>
<p><b>Nature of hearing</b></p>	<p>Informal hearings held in public unless STCT directs otherwise.</p>	<p>All hearings in public unless tribunal directs otherwise. Formality depends on category of case.  Normally no hearings for 'Default Paper' cases.</p>	<p>Hearings in public. TCC not bound by any legal or technical rules of evidence in conducting a hearing.</p>

<b>Decision Written or Oral?</b>	Oral decision at conclusion of hearing.  Written reasons available on request.	Oral decision may be delivered at end of hearing.  Decision delivered (or confirmed) in writing within 28 days of the hearing.	Oral decision at end of hearing or within 90 days.  No requirement for written decision.
<b>Timeframe</b>	Aim: decision within 12 weeks of taxpayer lodging application for review of decision.	Various deadlines depending on category of case.	Aim: decision within 11 months from taxpayer filing notice of appeal.
<b>Rights of Appeal</b>	Appeal on a point of law to Federal Court.	Appeal on a point of law if permission (leave in Northern Ireland) is granted.	No right of appeal but decisions can be judicially reviewed on restrictive grounds.
<b>Award of Costs</b>	No award of costs.	No award of costs (with the exception of 'complex' cases) – unless wasted costs order or party acting unreasonably.	Yes – only in favour of taxpayer (if successful). No costs award if taxpayer unsuccessful.
<b>Decisions precedential?</b>	Non precedential.	Non precedential.	Non precedential.

### V SMALL TAX DISPUTE RESOLUTION RECONSIDERED

The survey of the three countries in this article highlights the following points of interest:

- a) Each jurisdiction has a specific forum or procedure to deal with small disputes. The abolition of the small claims jurisdiction of the TRA in New Zealand accordingly is out of step with the approach in these common law jurisdictions. Indeed, in very unequivocal terms, the September Submission states: 'An appropriate forum for micro disputes is necessary as a *basic right to justice*.'<sup>215</sup> (emphasis added)

<sup>215</sup> NZLS and NZICA, above n 18, [3.53].

- b) Filing fees are kept to a minimum, or are not charged at all (in the case of the UK). In Canada the fee is refundable if the taxpayer is successful or can be waived on hardship grounds. While the NZ\$400 non-refundable TRA filing fee was clearly the highest fee, it could be waived if the taxpayer was unable to pay or the issue was a matter of public interest. The Issues Paper, while acknowledging the size of the fee, did not consider it to be prohibitive.<sup>216</sup>
- c) Australia and Canada have preferred to define their small claims procedures by monetary limit (except for GST and HST in Canada where there is no such limit). The category approach adopted in the UK has the advantage that disputes are not excluded from streamlined processes simply because of an arbitrary monetary threshold – thresholds in both Australia and Canada, which have existed at these levels for a number of years, look decidedly on the low side. The ability for appellants in Canada to restrict the amount under appeal to C\$12,000 (or C\$24,000 for loss claims) ameliorates this issue to a degree, providing taxpayers the option of using the Informal Procedure for disputes which exceed this threshold. The UK approach recognises disputes vary based on issue and level of complexity – not simply on amount in dispute. However, in the UK, as has already occurred, disputes on the boundaries between the categories are likely to arise, for example where is the line between a more complex Basic case and a Complex case?
- d) None of the jurisdictions surveyed differentiate between small and very small disputes. The UK approach does provide some differentiation, dependent on the issue, level of complexity etc. The Australian approach clearly applies to what would be described as very small tax disputes - all other disputes (including small tax disputes) are heard by the AAT's Taxation Appeals Division. In Canada, the threshold is somewhat higher and would apply to a wider range of tax disputes. In fact, the C\$12,000 (NZ\$15,682.80)<sup>217</sup> threshold is broadly equivalent to the NZ\$15,050 (inflation-adjusted) threshold suggested by the Richardson Committee which would cover two-thirds of tax disputes in New Zealand. However, the September Submission observes that it would be uneconomic to take a dispute for this amount<sup>218</sup> and suggests an alternate process, including mediation, for tax in dispute up to NZ\$50,000.<sup>219</sup> For disputes above that level, the opt-out option (after the conference) would be available for taxpayers seeking quick dispute resolution.

Support for a higher threshold comes from Canada where the percentage of cases being heard in the Informal Procedure has dropped from 70 percent (the original target) in the mid-1990s<sup>220</sup> to 40 percent in 2006.<sup>221</sup> There could be a range of explanations for this fall, including the C\$12,000 threshold is too low.

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<sup>216</sup> Inland Revenue and the Treasury, above n 16, [8.40].

<sup>217</sup> Using a cross rate C\$1 = NZ\$1.30, MSN, above n 185.

<sup>218</sup> NZLS and NZICA, above n 18, [3.28].

<sup>219</sup> Ibid [3.56].

<sup>220</sup> Gallant, above n 207, 335.

<sup>221</sup> Hickey, above n 180, 2. However, the total number of cases heard under the Informal Procedure has increased 40 percent from 2003 to 2006, but at a slower rate of increase than the General Procedure: ibid 2.

Leading New Zealand tax practitioners interviewed in 2009 had mixed views concerning the threshold for a small tax dispute process in New Zealand, ranging from NZ\$20,000 (based on the level of dispute the Disputes Tribunal, a non-tax body, can consider with the parties consent) to a much higher threshold than the NZ\$60,000 suggested by the researchers.<sup>222</sup>

- e) Unlike the (former) small claims jurisdiction of the TRA, the small tax disputes processes in the three countries surveyed are not restricted to those disputes where the facts are clear and there are no significant legal issues of precedent involved.
- f) Prior to the small tax process formally commencing the revenue authority usually will have reviewed the case again – in the UK many disputes are resolved prior to or at the HMRC review stage.<sup>223</sup> The use of pre-conference hearings in Australia has also proven effective.<sup>224</sup> In Australia, applications for a review by the STCT can be made by letter or two-page application form (which includes reasons why the taxpayer believes the decision is wrong). The Canadian notice of appeal (for the Informal Procedure) is similarly short (two-pages) including a page for the taxpayer to state reasons why they disagree with the CRA's decision. Alternatively the taxpayer can institute an appeal by way of letter filed at any TCC office. The HMRC notice of appeal form, which is designed for any appeal to the First-tier Tribunal, at seven-pages (with provision for extra pages to be inserted if necessary) is more complex and less user friendly due to catering for all categories of appeal. It similarly requests applicants to explain why, with reasons, the taxpayer believes HMRC is wrong.

The requirements for either a taxpayer-initiated NOPA or NOR (where the dispute is initiated by the CIR) in New Zealand are more onerous than the examples referred to above - requiring *inter alia* a concise statement of the law (legislation and cases), the relevant facts and how the law applies to the facts. The procedural standards operating in New Zealand make no distinction between small, simple disputes and large, complex ones. 'The taxpayer that wants to challenge a minor tax matter is automatically put at a disadvantage because most (if not all) taxpayers would find it difficult to comply with [the] requirements'.<sup>225</sup>

- g) Not unexpectedly, the importance of flexible procedures, informality (of hearings),<sup>226</sup> timeliness and accessibility are emphasised in each jurisdiction, typically through statute and administrative directives. For example, in Canada

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<sup>222</sup> Peck and Maples, above n 31, [5.2.2].

<sup>223</sup> HMRC, above n 120 (*ARTG2010*).

<sup>224</sup> AAT, above n 58, 133 (Table A3.4).

<sup>225</sup> NZLS and NZICA, above n 18, [3.49]. The recommended restriction of CIR NOPAs to five pages where the dispute involves less than NZ\$5,000 (Inland Revenue, above n 15, [144] (SPS 10/04)) is welcome but does not level the playing field for inexperienced taxpayers. In addition, this length can increase, where for example the issue is complex or there are multiple issues: *ibid*.

<sup>226</sup> Judge Barber, the only remaining TRA judge, has indicated he sees the TRA as a Court of Inquiry and as such 'he is free to adopt whatever process is necessary to achieve a just outcome.': NZLS and NZICA, above n 18, [3.54].

under the Informal Procedure, the hearing does not have to follow legal or technical rules of evidence and the TCC's decision has no precedential value. Decisions may be given at the end of the hearing or within a short period after. Time limits for the small tax dispute processes (and various stages) differ. In Australia the aim is resolution within 12 weeks from the lodgement of the taxpayer's application with the STCT. This contrasts with 11 months from the date the taxpayer files the notice of appeal in Canada. Achieving these targets has proven more difficult – 22 percent of applications in the 2009-2020 reporting year in Australia met the required standard – an increase on prior years.<sup>227</sup> Somewhat more favourably, in Canada, Lamoureux concluded 72 percent of cases studied were concluded within 12 months.<sup>228</sup>

- h) Rights of appeal are limited in Australia and the UK (with leave) to points of law. In Canada, appeals (in the form of judicial review) from Informal Procedure cases are restricted to errors of law and matters akin to breaches of natural justice. The Issues Paper cites lack of appeal rights as a reason for so few cases being heard by the small claims jurisdiction of the TRA. The author does not believe this is a significant concern for taxpayers with small tax disputes – a view tentatively supported by the approaches in the three countries reviewed in this paper.
- i) During the consultation on the proposal for a new tax chamber in the UK, concerns were expressed that an award of costs against a taxpayer may deter them from pursuing an appeal.<sup>229</sup> This may explain the approach ultimately adopted in the UK – with the exception of Complex cases, the First-tier Tribunal has no general power to award costs. It can only make a wasted orders costs order or an order against a party who acts unreasonably. In making any costs order, where an individual is concerned, the person's means are also taken into account. The approach in Canada is even more taxpayer-favourable – costs may be awarded only in favour of the taxpayer where the judgment reduces the aggregate of all amounts in issue, or increases the amount of loss in issue, by more than one-half. Costs cannot be awarded in favour of the Crown. In a similar move not to discourage taxpayers, in New Zealand the TRA can only award costs if it dismisses a challenge as being vexatious, frivolous or for the purpose of delay.

## VI CONCLUSION

A number of the objectives of the Richardson Committee – including resolving disputes without recourse to the courts - have been achieved in varying degrees. However, this has come at a greater dispute cost – a cost which is too great for many taxpayers where the amount of tax in dispute is small and has deterred them from proceeding with their dispute. The lack of access to resolution for such disputes negatively impacts taxpayers' perceptions of fairness and potentially the levels of taxpayer voluntary compliance.

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<sup>227</sup> AAT, above n 58, 26 (Table 3.10).

<sup>228</sup> Lamoureux, above n 196, 19.

<sup>229</sup> Young, above n 169, 2.

Recent administrative changes implemented by Inland Revenue, including the ability to opt-out of the process after the conference and limiting the length of NOPAs, are positive steps. However, these changes do not alter the fact that the dispute process essentially provides 'a one size fits all' procedure for tax disputes, irrespective of their complexity and the amount in dispute. It is unfortunate that, due to the restrictive criteria for cases to be heard in the small claims jurisdiction of the TRA (and its corresponding limited utilisation), the *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ) has abolished this capacity of the TRA and has not replaced it with an alternative forum. This is out of step with other common law jurisdictions which have a forum or process for hearing such disputes, a fact acknowledged in the Issues Paper.

The review undertaken in this article highlights some key themes with the small tax dispute procedures adopted in the surveyed countries. Flexible and informal procedures aim to ensure tax disputes are resolved in a timely and inexpensive manner. Timeliness, however, is a difficult aim to achieve. Application to the forum is (in Australia and Canada, at least) by way of a simple, two-page form which does not require the taxpayer to detail the law related to their dispute. Filing fees are low or non-existent. Access to the small claims procedure is either determined solely by monetary threshold or category of case. The restrictions imposed in New Zealand for access to the TRA in its (former) small claims jurisdiction (clear, undisputed facts and no significant legal issues of precedent) do not exist. Rights of appeal may be limited as are awards of costs. There is no separate treatment between 'small' and 'very small' disputes. These jurisdictions, except for the UK approach, simply differentiate between (very) small and all other tax disputes. Further research could consider whether in fact disputes procedures should distinguish between 'small' and 'very small' tax disputes. A consideration of alternative dispute resolution (ADR) for small (and very small) tax disputes, such as mediation and arbitration, is another area for future research.

To ensure that the tax system is perceived to be fair and that justice is available for the smallest of dispute, the author concludes that – in line with the Richardson Committee in 1994 – New Zealand should reconsider the need for a separate forum or procedure that allows the 'fast-tracking' of small tax disputes.



## **A COMPREHENSIVE LLB TAX TEACHING PROGRAM**

KEITH KENDALL\*

### **ABSTRACT**

Teaching taxation presents peculiar challenges for academics, especially when delivered as part of a law program. This paper documents the approach taken in the two-subject taxation course available as part of the LLB program at La Trobe University. Particular attention has been given to the design of the assessments used in each subject, which include an optional moot, in-class presentation and extended research paper. The paper concludes by identifying those features of these taxation subjects to suggest a model generalisable to the delivery of other law subjects.

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## I INTRODUCTION

Teaching taxation as part of any undergraduate curriculum presents special challenges. From the students' perspective, this is most likely due to the interdisciplinary nature of the subject, with elements of law, accounting and economics, at a minimum, featuring heavily. Additionally, the legal content of taxation itself, with a heavy emphasis on both complex statutory provisions and equally difficult case law, contrasts with other law subjects which usually can be safely categorised as biased towards one or the other. As well are common preconceptions that taxation study involves complex legal technicalities, heavy mathematics and little in the way of recognisable coherent legal policies and principles.<sup>1</sup> Given these factors, it is little wonder that students in LLB programs,<sup>2</sup> especially those without a business (accounting, finance and/or economics) background, often feel intimidated when embarking on taxation as a course of study.

The challenges are no less on the side of those delivering these courses. In addition to the problems that students face, lecturers are presented with the issue of designing courses that are engaging and motivating to a student audience that is often skeptical of taxation's relevance to their future plans. Much of the literature that considers these student engagement issues does so in the context of teaching taxation as part of an accounting degree program.<sup>3</sup> As taxation forms an integral component of most accounting degrees, lecturers in such programs are much less likely to be confronted with such skepticism as opposed to their colleagues in LLB programs.

This paper considers the approach taken at La Trobe University in incorporating taxation subjects into its LLB program. Designed specifically to be distinct from the subjects offered as part of the accounting courses, the taxation program in the La Trobe LLB comprises of two subjects that are designed to build on each other. The first of these is Income Tax Law (ITL), which is followed by Advanced Tax Law (ATL). The relative roles of each subject are described more fully in the next section.

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<sup>1</sup> See Michael Oberst, 'Teaching Tax Law: Developing Analytical Skills' (1996) 46 *Journal of Legal Education* 79, 80.

<sup>2</sup> LLB programs are used in this paper as a shorthand label for entry level law degrees and, therefore, comments are equally applicable to the relatively new Juris Doctor (JD) programs that are being offered at some Australian law schools.

<sup>3</sup> See, for example, Jennifer Butler, 'Researching Tax Using Technology: A Survey of Student Attitudes' (2006) *Journal of the Australasian Tax Teachers Association* 178; Lin Mei Tan and John Veal, 'Tax Knowledge for Undergraduate Accounting Majors: Conceptual v. Technical' (2005) 3 *eJournal of Tax Research* 28; Colleen Fisher, Judy McDonald and Katherine Ritchie, 'Bridging the Gap - The Challenge of Teaching Tax in a Multicultural Classroom', paper presented at the 17<sup>th</sup> Australasian Tax Teachers' Conference, January 2005, Wellington, New Zealand; Bernadette Smith and Sonia Shimeld, 'Drawing Accounting Students into Tax', paper presented at the 17<sup>th</sup> Australasian Tax Teachers' Conference, January 2005, Wellington, New Zealand; Lin Mei Tan and John Veal, 'Tax Curriculum in New Zealand Approved Tertiary Educational Institutions', paper presented at the 15<sup>th</sup> Australasian Tax Teachers' Conference, January 2003, Wollongong, Australia; Andrew Maples and Adrian Sawyer, 'Simulating Professional Experience through a Case Study: Assessing the Delivery of Transferable Skills from the Students' Perspective', paper presented at the 12<sup>th</sup> Australasian Tax Teachers' Conference, January 2000, Melbourne, Australia; Helen Hodgson, 'Teaching Legal Skills to Commerce Students or Turning a Commerce Student into a Tax Specialist', paper presented at the 8<sup>th</sup> Australasian Tax Teachers' Conference, January 1996, Brisbane, Australia.

As at November 2011, ITL had been taught eight times (since 2004) and ATL four times (since 2007). As such, this paper serves two purposes, being an exercise in reflective teaching as described by Biggs and Tang<sup>4</sup> designed to improve the content and delivery of these two subjects, and also as a record for what has transpired, with a view to allowing other teachers to adopt and/or adapt the techniques and methods used.

The next section of the paper sets out the basic design of these two subjects, including a brief overview of the assessment tasks used. This is positioned in the context of teaching theory, focused on the higher education sector. The section following that briefly discusses the notion of principles-based teaching, which is an underlying principle used in the delivery of these subjects. Following this, a more detailed discussion of the assessments and the experience taken from their implementation is provided. These observations are collated to suggest a model in the final substantive section that may be adapted for use for other legal disciplines. Short concluding comments are then provided in the final section.

## II COURSE DESIGN

Taxation law was reintroduced into the LLB curriculum at La Trobe Law in 2004.<sup>5</sup> At first, taxation was limited to a single offering, Income Tax Law (ITL). This was (and still is) delivered in the standard lecture-tutorial mode, with a two-hour lecture and one-hour tutorial across a thirteen week semester. While the major opportunity for interaction is in the tutorials, lectures have tended to be generally of medium size (55 to 70 students), so some moderate interaction takes place in this environment.

The assessments used in ITL consist of two tasks, with students provided with a choice in respect of the first. This first choice is between a moot (undertaken as group work) and a problem-based written assignment (undertaken individually). The second task is a traditional open-book written examination of two hours duration held in the standard University examination period.

With the growth in popularity of ITL, a second subject, Advanced Tax Law (ATL) was introduced into the curriculum in 2007. Unlike ITL, ATL is offered in intensive mode, with all classes taking place during one week in the break (either summer or winter) immediately following the last regular semester in which ITL was taught (i.e. winter break if ITL was taught in semester one). Cohorts have tended to be much smaller (which is to be expected, with ITL as a prerequisite for ATL<sup>6</sup>), allowing for a much greater level of interaction. This interaction culminates in the last two days of classes, in which the students effectively take over the leadership of the class (as part of an assessment task).

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<sup>4</sup> John Biggs and Catherine Tang, *Teaching for Quality Learning at University* (Open University Press, 3<sup>rd</sup> ed, 2007) 41-46.

<sup>5</sup> LLB students wishing to study Taxation had previously been referred to the School of Accounting to undertake the unit offered as part of the B.Com curriculum.

<sup>6</sup> One student to date has not completed ITL, although they had completed the equivalent subject at another university (and undertook ATL for cross-institutional credit).

The assessment in ATL comprises of two tasks, being an in-class presentation of half an hour's duration and a research paper. Each assignment is worth 50% of the student's final grade. Both tasks are undertaken individually. For each project, the student is able to choose their own topic, in consultation with the lecturer, with only minor restrictions on the presentation (topics that are not covered in the formal syllabus for ITL or ATL and have not been chosen by a classmate). Choice of topic for the research paper is limited only by the topic's feasibility for the parameters of that assignment.

The two primary features of both subjects are the use of principles based teaching and the specific design of the assessment. In brief, principles based teaching is designed to present the principles underlying the relevant law before analysing the technical content (including the specific wording of the relevant legislation). This provides students with a frame of reference by which they can understand the technical content of the law, building on prior knowledge and not losing sight of the forest for the trees. This is a form of constructivism in teaching and falls within Biggs and Tang's preferred Level 3 theories of teaching.<sup>7</sup> This approach to teaching is discussed further in the next section.

The intention behind ITL is to provide a broad foundational knowledge of taxation, which will provide students with a sufficient understanding of the basics of the area to contribute on at least a small scale should they enter tax practice. This goes beyond the mere issue-spotting ability Oberst attributes to many taxation courses taught in law degrees in the United States.<sup>8</sup> ATL then seeks to build upon this foundation by providing students with the opportunity to develop some specialist knowledge in one or two areas.

The net effect of the complete course is that deep learning, where students actively engage with the subject material and achieve a level of understanding in which the relationships between complex concepts are realised,<sup>9</sup> is fostered while recognising the practical limitations of the modern university classroom. Taxation cannot be taught in a vacuum; some technical detail needs to be transmitted to the students for the concepts to have meaning. This serves the purpose identified in the following section, at least to a limited extent, of preparing students for a professional career in taxation. To the extent that technical knowledge is required, students may adopt surface learning techniques such as rote learning and memorisation.<sup>10</sup> While not ideal, the realities of teaching an inherently complex subject such as taxation in a thirteen-week semester coupled with other practical restrictions, such as a large part-time student cohort with many demands on their time, inhibits the ability to foster a purely deep learning approach.<sup>11</sup> To mitigate these limitations, analysis of technical content and assessment that are

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<sup>7</sup> Biggs and Tang, above n 4, 20-21.

<sup>8</sup> Oberst, above n 1, 80.

<sup>9</sup> Biggs and Tang, above n 4, 24.

<sup>10</sup> See Biggs and Tang, above n 4, 22-25 for further discussion of the distinction between deep and surface approaches to learning.

<sup>11</sup> A mix of teaching approaches is recognised within higher education literature as being appropriate, if not inevitable. This is an observation applicable across all subject disciplines and is consistent with the reflective approach to teaching that members of academe are encouraged to adopt; see Heather Fry, Steve Ketteridge and Stephanie Marshall, *A Handbook for Teaching & Learning in Higher Education – Enhancing Academic Practice* (Kogan Page, 1999) 210-213.

likely to lead to a surface learning approach is restricted to ITL, with ATL designed to encourage the more desirable deep learning leading to better understanding of taxation concepts. This is consistent with the more homogenous student cohort undertaking ATL, who are particularly characterised by choosing to take this subject to identify themselves (whether to potential employers or other third parties) as having obtained a higher level of achievement in undergraduate taxation study than students having completed only ITL.

Finally, to provide a context in which student learning can take place, and also to encourage students to adopt deep learning techniques, an explicit theme is adopted in each subject. This is intended to provide a purpose for student learning, a reference point to allow them to which they may constant refer. By doing so, sight of the forest is not lost among the trees of legislative and case law detail that is studied. The respective themes used in each subject may be loosely referred to as tax planning in ITL and tax reform in ATL.

The focus on tax planning<sup>12</sup> in ITL requires students to, for example, appreciate the distinction between capital and income receipts and the implications of so classifying a specific receipt. The purpose of this theme is not so much to encourage tax planning per se, as such an approach can have clear negative implications, but rather to foster deep learning, in that students will often be required to adopt a reverse approach to answering questions compared with the method normally used. Students will be able to respond to such questions adequately if they have properly engaged with learning the material. For instance, a traditional client advice problem would pose a specific fact scenario and ask the student to apply the law in resolving the client's query. This is also the case for a typical problem in ITL. It is the extension questions where the difference comes in. The traditional model typically alters some aspect of the original fact pattern and requires students to revise their answer accordingly. While this may test a broad spectrum of the knowledge covered in a course, students may adopt surface learning approaches in that the alteration may prompt particular responses or signal where students may expect to find the answer. More to the point, students go through the same thought process as for the original question of comprehending a fact pattern, identifying the relevant law and then applying that law to resolve the questions posed. Under the rubric of tax planning, though, a typical extension question in ITL will ask an open ended question along the lines of "what would you change about the proposed transaction to produce a more favourable tax outcome?". Such questions typically deal with very fundamental matters, as opposed to the cynical identification and exploitation of perceived loopholes or artificial arrangements. Common examples used in ITL are converting an income stream (taxed as ordinary income) to a lump sum such that it is treated as a capital receipt, which may then allow access to the CGT discount or be offset against prior year capital losses, neither of which are treatments available to ordinary income receipts. The fact pattern in the High Court's decision in *FCT v Hart*<sup>13</sup> is studied as a prime case study of a practical example of (albeit ineffective) tax planning, largely

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<sup>12</sup> While inclusion would have been likely in any event, as a direct result of the tax planning theme two of the 13 lectures are devoted to anti-avoidance to ensure that students appreciate the role of legitimate tax planning and are able to distinguish this from the illegitimate practices of tax evasion, tax fraud and tax avoidance.

<sup>13</sup> (2004) 217 CLR 216.

as it is relatively simple (compared with the fact patterns of other anti-avoidance cases), relies only on substantive law that is covered in the syllabus (primarily s 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) and its predecessor) and does not depend on the exploitation of any special concessions (unlike most other schemes subject to Part IVA of the *Income Tax Assessment Act 1936*).

The tax reform theme in ATL provides an alternative focus from that in ITL, but has the similar advantage of fostering deep learning. Arguably, the deep learning encouraged in ATL occurs at a higher cognitive level than that in ITL. In ITL, students still take a positivist approach, applying the law as it currently stands. The tax reform theme of ATL, in contrast, requires students to take a more normative view of the law and actively forces students to question the current form that the law takes. This goes beyond mere policy inquiry; students are required to critique the law as it currently stands and, especially for the research assignment, not only identify problems with the current law and why these are problems, but to provide solutions as to how the law should be reformed to solve the identified problems. Vague discussion of theory or references to public policy are insufficient; students must provide solutions. For example, how particular provisions should be redrafted or repealed, in all cases being demonstrably cognisant of the predictable consequences of such changes. In the context of the principles based learning described in the next section, this process takes students one step further back in the legal process; whereas the principles based learning approach provides the intended effects of the law as a framework for understanding the existing provisions, the tax reform theme in ATL forces students further back to decide what those intended effects should be (including questioning whether the current intended effects are appropriate).

The next section provides a discussion of the concept of principles based learning. This is the technique that has been employed in teaching the La Trobe LLB tax program to facilitate the deep learning that represents the course's ultimate objective.

### **III PRINCIPLES BASED TEACHING**

One major challenge in teaching tax law is the temptation that students face to learn tax as a series of unrelated rules. This is the case regardless of the student's educational background. Students who have not done any previous accounting studies do not have a body of prior knowledge that they can readily draw upon. Accounting students, though, will realise very quickly that there are significant differences in the specific application of accounting principles as opposed to tax rules, despite dealing with similar subject matter. Students who view taxation as a series of unrelated rules are likely to undertake surface learning techniques with the result that they acquire very little actual knowledge of taxation.

To mitigate against this prospect, where possible, the content of the law is explained in terms of a general framework based on the intention underpinning the relevant provisions; these are the principles to which the title of the technique refers. This framework is couched in terms to which students should be able to relate. The technique comes into its own primarily with intermediate to advanced topics.



Once fundamental concepts have been learnt and understood, the principles based teaching framework may be used to greater effect. The framework is constructed relating the material under inquiry to the knowledge that has already been obtained and in this way is an application of Biggs and Tang's constructivist learning methodology, where students build upon their existing skill or knowledge base (rather than acquiring information anew).

To illustrate, one substantive area in which this approach is taken is with dividend imputation. Dividend imputation is first explained as rendering corporate tax to be a prepayment of shareholder tax (rather than a separate tax in its own right). This comes about through the gross-up and tax offset mechanism and is illustrated with numerical examples, particularly in explicit contrast with the treatment under the classical system of dividend taxation. Students by this stage of their learning are familiar with the concept of income from business and income from property being two categories of ordinary income, as well as the notion that a company is a legal entity separate from its shareholders. The classical system demonstrates the historical issue of double taxation of company profits, and contrasted with the relief from double taxation provided through imputation. The tax offset mechanism, in particular, is highlighted as providing the prepayment of shareholder tax effect.

One purpose behind this teaching technique is to equip students with the skill set to be able to cope with changes in the law. This is an outcome of obtaining deep learning that arises through close engagement with the subject matter. The deep learning fostered by taking a constructivist approach, relating the material first to concepts with which students are already familiar, allows students to appreciate better the operation of the law, be able to integrate subsequent changes in the law's technical detail much more quickly and be able to critique those changes (for example, as being inconsistent with the overall policy intention).

#### **IV THE ASSESSMENTS**

##### ***A Income Tax Law (ITL)***

Three forms of assessment are used in ITL, students choosing one of the first two and then undertaking a common traditional form examination. As has been noted, the demands upon this subject are not conducive to fostering only deep learning, so elements of the assessment used may be open to the criticism that students may adopt surface learning techniques. This is acknowledged, although the assessments are designed to mitigate this outcome as far as possible.

To assist in student preparation for the ITL assessments (although this is highly relevant as well for students taking ATL), a session is scheduled in the library every semester (more than one if there is sufficient demand) to train students in the use of the electronic tax resources that are available. This session is conducted by the Law Librarian at La Trobe University, goes for one hour and is scheduled outside of class time. While some students are disadvantaged in that the limited sessions may clash with another class, the librarian has been willing to date to conduct individual sessions if necessary. In any event, a quick survey of students during class prior to the session

being scheduled is usually able to identify a time that does not clash with another class for more than 90% of students in a particular cohort. While strictly voluntary, these sessions are very well attended (capacity is normally reached and additional sessions required) demonstrating their usefulness. This is further supported by the use of authorities (such as ATO Interpretative Decisions, Tax Determinations and overseas cases) in assessments outside those studied in the course. On inquiry, students have indicated that they located these sources through electronic resources covered during these training sessions. As indicated below in the discussion of the moot assessment, evidence in student performance supports the understanding that these sessions have had a positive effect on student research skills.

### 1 *The Moot*<sup>14</sup>

The moot is one of two choices that students have for their first assessment, worth 40% of their final grade.<sup>15</sup> Students undertake this exercise in groups of four, with one pair representing the Commissioner and the other the taxpayer. Students are encouraged to prepare in their groups of four, with the intention of fostering peer learning, as each member of the group picks up a line of inquiry and then tests it against the other group members. This interaction is encouraged as it is made explicit that marks are not dependent on having the stronger substantive argument (which would translate in real litigation as winning the case), so students are not effectively penalising themselves by assisting their opponents with their arguments. This approach has the additional benefit that students have the opportunity to immerse themselves in all aspects of the relevant law, fully working through arguments, rather than the relative surface-level approach that may be taken if merely anticipating possible arguments that the other side may raise. Further, any feedback that students provide to each other is a form of peer assessment, specifically formative assessment, since it is feedback received during the preparation stage and does not affect the final grade.<sup>16</sup> While Biggs and Tang argue that this form of assessment is generally more effective than traditional summative assessment,<sup>17</sup> it is often easier said than done to implement given the resource constraints in the modern university environment to provide opportunities for true formative assessment. The environment created here in the preparation stage for the moot provides an effective means by which students may obtain the benefits of formative assessment, especially through peer interaction (which also encourages independent learning) rather than viewing the lecturer as the sole oracle of all relevant information.

The exercise comprises of two components, a written submission and oral arguments. This is consistent with how other moot programs are structured within a tax

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<sup>14</sup> A more detailed exposition of the moot as employed in ITL is provided in Keith Kendall, 'Mooting in an Undergraduate Tax Program' forthcoming in the *Journal of the Australasian Law Teachers Association*.

<sup>15</sup> In 2004, the moot was compulsory (there was no option of a written assignment). While this did not cause problems in that year, the structure of the moot is such that problems are created if the number of students enrolled is not a multiple of four (24 were enrolled in 2004). The option of the written assignment was introduced in 2005 to allow an alternative where students could not find mooting partners.

<sup>16</sup> On the distinction between formative and summative assessment, see Biggs and Tang, above n 4, 163-165.

<sup>17</sup> *Ibid* 164.

curriculum.<sup>18</sup> Unlike Bentley's model, submissions in the ITL moot are required two weeks prior to oral argument. This is due to the different purposes for which the written submission is used from the Bentley model. While there is a common purpose in that the written submission is designed to give some notice to both the moot judge and the pair's opponents as to what arguments are to be raised, the assessment is more heavily weighted to the oral argument component. In reality, the written submission is a requirement that is imposed largely to ensure that students begin preparing arguments at an earlier point in time; by forcing a substantial component to be handed in earlier in the timeframe, students are forced to begin work earlier. The purpose behind forcing students to commence work earlier is to improve the quality of the oral arguments presented; the generally high standards achieved over the last eight years appear to have borne this expectation out.

Students are permitted to make amendments to their arguments between finalising their written submission and presenting their oral argument. This recognises that students will continue to research and refine their arguments during this interim period, possibly jettisoning some arguments that they realise are not tenable, or discovering an alternative line of argument based on an authority they had not previously found. Such changes are required to be communicated to their opponents reasonably contemporaneously with the change being finalised. This applies for both additional arguments (so opponents have as much notice as possible to prepare counterarguments) and removing arguments (so opponents do not waste any additional time preparing rebuttals). This is consistent with the collaborative learning purpose of this assessment.

The problem that is set is always based on an actual transaction (or currently controversial issue that can be packaged sufficiently well into a transaction) consistent with ITL's practical focus. The sources for such material are varied. In some cases, they are based on a transaction in respect of which the lecturer (or a former colleague) has had to provide advice, or a case that is currently before the courts<sup>19</sup> or a current controversy as indicated in an ATO publication.<sup>20</sup>

In the case of the latter two sources, which are based on publicly available material, care is taken in the wording of the problem to ensure that easily identifiable searchable terms present in the source material are not used in the moot problem (for example, sell-back rights and earn-out rights). The content of such concepts is used, but a different label is attached, to guard against the prospect of students locating the source material and thereafter relying on that material as the sole source for their research.

Notwithstanding this step, many students have found the source material when researching their arguments. Three positives are borne out of this. First, students who do uncover these sources have almost universally attended the library training session

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<sup>18</sup> See, for example, Duncan Bentley, 'Mooting in an Undergraduate Tax Program' (1996) 7 *Legal Education Review* 97, 115.

<sup>19</sup> For example, the fact pattern in *FCT v McNeil* (2007) 229 CLR 656 was used as the basis for the moot problem fact pattern in 2007, prior to the High Court handing down its decision in that case.

<sup>20</sup> A transaction incorporating an earn-out right was used in the moot problem in 2008 and 2010 as a result of the controversy surrounding this issue since the ATO's release of TR 2007/D10.

described at the beginning of this section and have generally acknowledged that they expect they would have been unlikely to have found these materials without having undertaken that training. Note that the moot problem was worded carefully to avoid near-unique search terms, so it is only by using alternative advanced research methods (as opposed to basic word searches) that students are able to locate these sources. Second, the non-use of easily identifiable labels (usually coupled with the use of a deliberately different label) requires students to recognise and align the substance of the moot problem with that in the source material. Third, there has not been a single instance where students have relied solely upon this material as the basis for their argument. Not all have recognised the source material as being such, rather, these students have recognised the material as being on point, but have used it as but one component of the overall foundation for their argument. But, most pleasing, even those who have recognised the source material as playing this role (remembering students have been told that the moot problem is based on an actual problem, but they are not told anything more, including whether it was a private transaction, current litigation or something else) have continued their research and fashioned much stronger arguments as a result.

The purpose of the moot is explained as testing students' knowledge of substantive taxation law. To this end, a number of measures are put in place to ensure that aspects that may affect an individual student's performance are not confounded (as far as possible). Problems are usually set as being heard by the High Court, to pre-empt any argument that the court is bound by some precedent. This also guards against the potential for any student to cease researching if they believe they have found "the" binding authority.

The potential problem associated with appellate litigation, that generally only arguments used previously in the lower court hearings may be used, is pre-empted by not detailing the arguments that had been used and instructing students that they may assume that any argument they formulate has indeed been used in the lower courts.

To assist students with potential nervousness and to ensure they focus on the substantive tax law raised in the problem, usual procedural requirements are dispensed with during oral argument. An unused tutorial room is normally used for the hearings, rather than the dedicated moot court, formal address (Your Honour, my learned friend)<sup>21</sup> and introductions are not compulsory, participants stay seated and business attire is not required. This is to guard against the possibility that students may perform poorly for lack of familiarity with procedural requirements, or neglect their preparation of the substantive tax law in familiarising themselves with these procedures.

The oral arguments themselves are conducted in one hour blocks. Each pair is allocated twenty minutes total speaking time, with each partner to speak for at least five minutes. This last requirement acknowledges that there may be some unevenness in the amount of time each partner may require.

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<sup>21</sup> Experienced mooters have indicated that they are more comfortable maintaining the formal address due to this experience. As such, students are told they may adopt the form of address with which they are most comfortable.

Unlike many competitive moots, opponents alternate in the delivery of their arguments. For example, if the pair representing the taxpayer speak first, the order of argument will be TP(A), FCT(A), TP(B), FCT(B).<sup>22</sup> This is designed to allow students the opportunity to respond to arguments that their opponents have raised, rather than needing to anticipate what their opponents are likely to say.

Mooters are subjected to questions from the bench during oral argument. Students are advised in advance of this prospect; it is not merely a matter of being able to deliver a prepared argument verbally. The unpredictability of the questions as part of this exercise requires students to be genuinely familiar with the material to ensure that they are not caught out by an unexpected question. The unpredictability of this element of the assessment is designed to promote deep learning as students undertake their preparation.<sup>23</sup>

A potential problem is that each member in a pair is awarded the same mark. This was a deliberate decision and has been in place since ITL's first offering in 2004. This decision reflects the team nature of the exercise and is designed primarily to remove conflict within groups, to encourage pair members to act co-operatively with the knowledge that better performance by one member means an improvement in the mark for the other. As such, students are free to allocate tasks how they see fit, with one, for example, taking major responsibility for research if the other is a better oral arguer. It also pre-empts any disputes subsequent to oral argument that if one member argues for more of the pair's aggregate twenty minute allocation than initially expected, the other member is not unduly disadvantaged by being denied their chance to shine. Of course, this raises the problem of potential free riders, although this is mitigated by the mark allocation being explained clearly to students, both verbally and in writing, and requiring students to select their own moot partners (so they are at least partly to blame for choosing a poor partner). Despite initial concerns, there has not been a single complaint about this mark allocation in eight years.

This last observation is an example of how what Biggs and Tang refer to as a Theory Y assessment may be used in tax teaching.<sup>24</sup> Theory Y teaching takes place where responsibility is placed on the students for their learning, rather than requiring them to operate within strict parameters. Given the practicalities of the modern classroom, this can be a difficult ideal to achieve, but this moot assessment demonstrates to some extent that it is not a utopian ideal.

## *2 The Written Assignment*

As noted, students in ITL have the option of choosing a more traditional written assignment in preference to the moot. The form of the assignment is a client-focused problem in which the student is required to provide advice on the expected tax

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<sup>22</sup> The first speaker is not given the opportunity for additional right of reply speaking time after the fourth speaker.

<sup>23</sup> It is also worth noting that the questions from the bench are generally handled very well, demonstrating the understanding that is claimed.

<sup>24</sup> Biggs and Tang, above n 4, 37-39.

treatment. As with the moot, the fact pattern is based on an actual transaction or controversy taken from a practical context.

Unlike the moot, which focuses on teamwork and oral arguing skills, the written assignment requires students to consider alternative means of structuring the relevant transaction (an example is the sale of a business) in a more tax effective manner. While there are various permutations that this can often take, there is usually a specific method in mind. An example that has been used is during a corporate takeover, the students may propose that the target shareholders accept shares in the acquirer rather than cash as consideration for the sale. Such a restructure allows the shareholders access to the scrip-for-scrip CGT rollover contained in Subdivision 124-M of the ITAA 1997, allowing a deferral of any CGT that would otherwise arise. Alternatives that achieve the desired effect are given appropriate credit and, therefore, this assessment is aligned with Biggs and Tang's notion of a standards model of assessment, in which marks may feasibly be awarded for qualitatively equal yet substantively different student responses from the answer that the lecturer expects.<sup>25</sup>

Unlike the moot, students undertake the written assignment individually, so the opportunities for peer and formative assessment are not available to the same extent. Deep learning is promoted, though, through the restructuring element described in the previous paragraph.

Students are actively encouraged to undertake the moot where possible, with the written assignment presented as the option available only for students who feel strongly compelled not to participate in the moot. While there was some variability when enrolments were small, ITL enrolments appear to have now stabilised in the 55-70 range, with roughly two-thirds of every cohort choosing to undertake the moot.

### *3 The Examination*

All students sit a common examination at the end of the semester in the standard University examination period worth 60% of the final grade. The examination is open book and consists of three questions, two problem-type questions (client advice scenarios) and one short essay. The questions are attributed 40, 10 and 10 marks respectively, with the 40 mark question being one of the problem questions.

Both problem questions feature a tax planning element. The larger problem question is normally structured by presenting a fact pattern including the client taxpayer's personal financial circumstances, then presenting a proposed transaction, such as the purchase of a business, with the requirement to identify the most tax efficient means of raising the required funds.<sup>26</sup> This requires demonstration of such matters as recognising when the CGT discount may apply, when it is most appropriate to use capital losses (against non-

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<sup>25</sup> Ibid 177-178.

<sup>26</sup> While calculations are not assessed directly and students are not required to calculate precise tax liabilities, the figures presented are sufficiently far enough apart so that students should recognise that the requisite after-tax funds will not be raised through a single transaction. Students are not penalised if precise calculations determine that insufficient, though approximate, funds would be raised with the transactions suggested. As discussed, marks are allocated based on the knowledge of legal interactions demonstrated.



discount instead of discount capital gains), interactions with tax losses, the availability of concessions such as the main residence exemption and rollovers and the loss of deductibility of interest where loans change purposes. These interactions are unlikely to be recognised where students take a surface learning approach, for, while tutorial problems are designed to provide students with practice at recognising these interactions, they are generally not explicitly discussed in class except in response to direct questioning. Due to the number of marks allocated to this question and the complexities in assessing the tax planning component, a large detailed fact pattern is required. In practice, the fact pattern alone has tended to span at least one full A4 page (single spaced). The quality of answers provided will inevitably be reduced if students were reading this fact pattern for the first time under exam conditions.

To mitigate this potential problem, the fact pattern to this large question is released to students prior to the examination, normally in the last week of classes. This gives students at least two weeks to become familiar with the fact pattern. Students are also explicitly informed that the fact pattern will be identical to that in the examination, so students do not waste time under exam conditions confirming that there are no differences with the fact pattern that they have studied. Note that it is the fact pattern only that is released; the questions posed in the examination are not included.

It is predictable that students will attempt to anticipate the questions that will be asked in the examination based upon their reading of the fact pattern and tailor their study accordingly. While this may encourage a surface learning approach whereby students research answers to the anticipated questions, script these in advance and use these scripted responses in the examination,<sup>27</sup> this is mitigated by a number of means. First, the surface learning approach will not be adequate for the remaining two questions, which are unrelated to the large question (students are informed of this (non)relationship). Second, a surface learning approach, in any event, is unlikely to assist with tax planning requirements, which is dependent on recognising interactions, so an apparent surface learning approach is actually fostering deep learning across the material that is being studied. Third, there are a large number of issues that are embedded in the fact pattern, but only some are tested. Students are informed of this in advance. As such, a student who is able to anticipate correctly every possible question that could be asked and scripts answers to these questions has, in fact, covered in detail a very large proportion of the subject material.

### ***B Advanced Tax Law (ATL)***

The purpose of ATL, compared with ITL, is to allow students to acquire some level of specialist knowledge within taxation. In recognition of this purpose, a deliberate design decision was made not to include an examination as part of the assessment for this subject. While there is some technical content delivered in the form of traditional lectures, the absence of an examination allows students the freedom to recognise that they may be weak in a particular area and choose not to apply effort to understanding that part of the material. Given the control that students have over their assessments in this subject, it is theoretically possible for students not to understand any of the lecture

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<sup>27</sup> Note that the examination for ITL, as with most subjects in the LLB program at La Trobe University, is conducted under open book conditions.

material, yet perform very well. This, of course, requires students to go completely outside of the subject syllabus and learn and understand a discrete area (or two) under their own efforts, with little or no guidance. Such an outcome is in perfect keeping with the intended learning outcomes of this subject, which is designed to foster independent learning and develop research skills.

The theme of ATL is tax reform and, as such, the lecture material presented focuses on more recent developments in the law. Topics that have been covered include consolidation, GST, international tax, the taxation of off-market share buybacks and the debt/equity rules. Supplementing this lecture material, where possible, an external presenter with experience in the tax reform process is brought in to give a presentation to the class. For example, in 2009, a member of the Henry Review gave a presentation on the machinations and processes of that Review, providing an insight into the tax reform process that students would be unlikely to acquire from reading texts or their own efforts.

Deep learning is pursued on two levels in ATL. First, the tax reform theme explicitly requires students to question the nature and principles of the law that is being studied and not accept these at face value. In other words, a positivist approach, in which the law is applied as it stands (perhaps tested only peripherally with minor questions focusing on tax policy), is replaced with a more normative approach requiring students to consider what they think the law should be (and, more importantly, why). Second, both forms of assessment conform to Biggs and Tang's Theory Y teaching model, in which students take responsibility for the content of their learning. Given that the impetus for technical knowledge acquisition has been satisfied through studying ITL (ITL being a prerequisite for studying ATL), there is much greater freedom for such open-ended assessments to be used.

The intensive mode in which this subject is delivered creates an environment in which students have an unusual opportunity to form a cohesive group bond, which aids the achieving of the intended learning outcomes. In particular, this environment generates an excellent group dynamic that manifests itself most clearly during the class presentations, discussed in the next subsection. This is particularly important to achieve, since students are informed that they are expected not only to attend their classmates' presentations as a show of courtesy and support, but active participation forms part of their grade. While this stick (as opposed to carrot) approach to encourage participation is present, the feeling is that, at least to date, this has not strictly been necessary since the dynamic generated over the course of the classes naturally promotes such active engagement.

### *1 The In-Class Presentation*

The first form of assessment is an in-class presentation and is worth 50% of the student's final grade. This is essentially in two parts, being the presentation itself and the level of participation exhibited (primarily demonstrated through asking appropriate questions) in classmate presentations. The presentation and levels of participation are linked, though, as students are informed that one of the grading criteria for their presentation is the level of class interaction that is generated. As such, there is

something of a feedback loop occurring, with students provided with the opportunity to support each other in a productive manner, while concurrently addressing their own self interest (in terms of maximising their own mark).

Presentations are for half an hour and are conducted after lectures have concluded. To date, this has resulted in the last two days of the five day class being dedicated to class presentations. Students are required to use a Powerpoint presentation and are informed that they may use whatever other visual aids that they wish. Students typically use at least one other visual aid, normally a handout, use of a whiteboard or overhead projector. Combinations of these aids are frequent.

Students are given free choice as to their topic, subject to three constraints, being that the specific topic presented cannot form part of the syllabus for ITL or ATL,<sup>28</sup> no other student presents on the same topic (a first-in-best-dressed policy is applied)<sup>29</sup> and approval of the lecturer (which, to date, has not been denied in any case except where another student has requested the same topic). In effect, the students are given control of the classroom and what topics are studied. This takes Biggs and Tang's Theory Y teaching one step further; not only are students being granted control of and responsibility for their own assessment, but they are also being given the same control of and responsibility for part of the subject syllabus and their classmates' learning.

Relating this assessment back to the overall objective of maintaining a practical focus and providing students the opportunity to develop skills that are useful in professional practice, the in-class presentation simulates the type of training presentation that a professional may be required to present within their firm or business. Such presentations are usually on some new development in the law, most typically a new case or new bill that changes the prior law to some degree. In these cases, the presenter is required to research this new development and become informed of it under their own efforts and then present to an audience of fellow practitioners who are knowledgeable of the basic tenets of the law, but not the specifics of the presentation's subject matter. For example, a presentation to other tax practitioners discussing a recent High Court decision dealing with capital gains tax will not need to address the capital/income distinction nor the structure of the capital gains tax provisions in the legislation, as the audience can be assumed to possess this knowledge already. The audience, though, is unlikely to be aware of the specific details of the High Court's decision and how this case sits within their existing knowledge of capital gains tax.

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<sup>28</sup> Recognising this parameter and the flexible nature of ATL, students are encouraged to approach the lecturer prior to the finalisation of the ATL syllabus if they have identified an intended presentation topic. This allows the lecturer to remove that topic from the ATL syllabus if it was intended to be included, allowing that student to present on that topic and satisfy the intended learning outcomes for this assessment.

<sup>29</sup> In some cases where students have requested the same topic, it is suggested that students co-ordinate the content of their presentations so that they are presenting on discrete elements of the same topic, for example, one presenting on the fundamental aspects of a particular area of the law, the other focusing on specific applications or advanced notions (such as peculiar concessions). In such cases, these presentations are scheduled consecutively, so that the remainder of the class may maximise their learning of the technical content by building upon the earlier presentation without the interruption of separate technical topics.

In the same way, ATL students are presenting to an audience with similar characteristics. Other members of the class can be assumed to have the technical knowledge that formed the content of the syllabus for ITL and ATL (representing one reason for disallowing students to present on these topics), but not the specific details of the presentation's focus.

Due to the nature of this exercise, students are not required to incorporate a tax reform element into their presentations (although some students manage to do so). Given the purpose of the presentation and the highly condensed timeframe in which preparation is undertaken (often approximately one week, including researching the relevant law), most presentations are primarily descriptive. Notwithstanding the tight timeframes in which the exercise is conducted, the vast majority of presentations are of very high quality. This demonstrates the success that the design of this assessment in motivating students to engage actively with their chosen material, being evidence of deep learning that is taking place (and the acquisition of genuine specialist knowledge).

## *2 The Research Paper*

The remaining 50% of the student's final grade comprises of a research paper that is completed sometime (approximately two months) after ATL lectures have ceased. A nominal word limit of 3,000 words is applied, but students are informed that this is not strictly enforced and they may exceed this if they believe appropriate. Students are informed that the purpose of the exercise is to engage closely with their chosen topic, not to comply with what is essentially an arbitrary word limit. Qualifying this position, though, is that students are informed that they are to write what is necessary to address the topic properly and no more; there is no reward for writing a longer piece per se, but padding is heavily penalised. This accords with the model of assessment advocated by Biggs and Tang that rewards engagement with the material, rather than adherence to arbitrary parameters, which is more consistent with Theory Y teaching.<sup>30</sup> At a practical level, the legitimacy of this instruction is demonstrated with two examples from the 2010 cohort; while the highest mark for the research paper was awarded to the paper that happened to be the longest that had been submitted in the four years (approximately 11,000 words), the second highest mark was awarded to a paper that was almost exactly 3,000 words long. In both cases, the student had defined and outlined an appropriate topic and addressed the thinking at a high level and arrived at their own well-reasoned conclusions, thereby earning their respective marks. Most students submit papers approximately 4,000 words in length.

As mentioned, students have free choice of topic and this, coupled with the advertised non-enforcement of the word limit, further aligns ATL with Biggs and Tang's notion of Theory Y teaching. Unlike the in-class presentation, the only restriction is that topics must be approved by the lecturer (solely to ensure that the topic is viable). Students may write on topics that had been covered in the syllabus for either ITL or ATL, there is no requirement that the topic be unique (in that no other student is writing on the same area) and students may write on the same area that formed the focus of their in-class presentation. While it may be anticipated that many students would choose the same area for both assessments, due to the economies of scale in the research aspects, of the

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<sup>30</sup> Biggs and Tang, above n 4, 39-40 and Chapter 10.

four cohorts, only one student has followed this path. The most logical explanation for this is that the different focus for each assignment, describing a new area of law for the in-class presentation compared with the tax reform emphasis in the research paper, causes students to choose separate areas for each assignment that are more conducive to the respective purposes of each assignment. Private conversations with students support this explanation; a large number begin preparation for the research paper with the intention of writing in the same area as that on which they presented, but soon afterwards discard this area in favour of a fresh topic. The explanation almost universally given is the inability to identify an appropriate tax reform angle to their presentation topic.

It is through this assessment that the tax reform theme is promoted. In particular, students are required to identify some area of taxation law that could be reformed. While this usually takes the form of an aspect of the law that is presently deficient and in need of improvement, students are advised that it is legitimate to write on an area of the law that they believe is presently sound, but other commentators believe needs to be reformed. In all cases, students are required to identify their area, identify the perceived problems with the current state of the law and then suggest solutions and explain why their proposed solution represents an improvement on the existing law.<sup>31</sup>

Students are further encouraged to attain high standards in their research and writing for this assignment by the prospect discussed in class of having their piece published in one of the tax journals, subject to being of sufficient quality (and the expectation of some review). At the time of writing, none of these research papers have been published, although an unusually high proportion of the 2010 cohort (approximately 50%) submitted papers of potentially publishable quality.

This final step represents a rare instance of one assignment constituting both formative and summative assessment. The research paper is summative in the sense that no feedback is provided during the preparation of the paper and the final mark awarded cannot be amended through additional work. Formative feedback is provided, though, in the shape of very detailed comments on where the paper can be improved (students have frequently expressed their appreciation of the level of detail of feedback received), mostly with a view to having the paper subsequently published. As the potential is provided for students to continue working on and improving their research paper with a further end goal in mind, the comments as well as the mark serve as formative feedback and contribute to the student's learning in the area, supporting the intended learning outcome of the student acquiring a deep specialist knowledge in a specific area.

#### **V A GENERALISABLE MODEL**

While this paper has focused on the design and delivery of a tax curriculum, there is nothing in the subjects as implemented that limits the model used to only tax subjects. The basic model is that the curriculum comprises of two subjects, the first designed to provide largely technical knowledge, while encouraging engagement and deep learning

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<sup>31</sup> In the case of students arguing that the law is adequate in its current state, students are required to explain why alternative reforms would not improve the law and why the present system is to be preferred.



with the material to achieve understanding, rather than mere recall. Students that cease their study of the area after the first subject should be reasonably well equipped to commence practice in that area; while it is not to be expected that they would operate professionally at anything above beginner level, they have been equipped with sufficient technical knowledge and skills so that they can learn quickly once commencing practice and constructively contribute to their respective employers.

The second subject provides students with a keen interest in the area (and lecturers should take the opportunity presented by the first subject to foster such keen interest) to acquire some specialist knowledge. While this may have the benefit of providing these students with a point of distinction should they seek employment in this area in the future, this benefit is a by-product of the learning objectives inherent in the subject's design. In particular, the design of the assessments and the classroom environment foster the deep learning that is the idealistic, but unfortunately often utopian, goal of all university education.

A number of modifications and adaptations to this model are inevitable in any subsequent implementation. For example, there is nothing compelling a moot to be offered as one of the assessments; the important aspect is that deep learning is fostered and that appropriate learning outcomes are achieved. Many of the specifics are likely to be dependent on the strengths and preferences of the lecturer; lecturers who are uncomfortable assessing active oral presentations are unlikely to adopt a moot enthusiastically.

It is suggested, though, that some aspects of the model should be adhered to. The intensive mode of delivery for the second subject, based on experience, is a core design feature. While this was initially implemented as a matter of convenience (largely as an opportunity for students to fast track their degree), the group dynamic that the intensive mode generates, particularly with a small cohort, creates an environment rare in the modern university where all participants are focused solely on the one subject area for the duration of the class. It is difficult to see how the consistently high quality student work that has been observed in ATL could be replicated in a traditional semester format.

Further, the assessment in ATL should be used in other second subjects. While the reform theme may be dispensed with in favour of an appropriate alternative focus (one that should lend itself to high level research), the presentation/research paper combination would appear to be most suitable to the learning objectives identified. Specifics such as the length of presentation (although it is suggested that this should be substantial – at least twenty minutes) may be varied, but the overall structure should be followed.

The disadvantage with structuring the second subject in the manner described is that such a subject becomes unwieldy with more than a small cohort and, consequently, is not amenable to mass delivery. This has the potential to act as a major hurdle to its ready adoption in the resource constrained environment of the modern university. It is at this point that the post-completion objective of publishing the research paper may mitigate this problem. As well as the benefits identified for students, appropriate



submission (to refereed/ranked journals) and structuring (attention to by-lines, possible co-authorship with the lecturer if appropriate) will result in these publications being included in the school or faculty's research report. While this is not the usual vision of research-led teaching discussed, it does represent a prospect where research and teaching activities can be linked, with the one supporting the other and mitigating the additional resources required to deliver a law program that aims to reach the ideals that are often seen as unachievable.

## **VI CONCLUSION**

This paper has documented the experiences over the last eight years that have been taken from implementing and delivering the undergraduate taxation program conducted in the School of Law at La Trobe University. These experiences have been positioned within the body of higher education theory, particularly the aspirational goal to engender deep learning in students. The notion of principles based learning, with its application to the teaching of taxation law, was also presented.

The overall design of the assessment tasks used in the two subjects described is aimed at allowing students to develop skills that they may have had limited, if any, opportunity to form during their previous LLB studies and building upon the skills already attained. In this manner, the assessments build upon each other and form a coherent tax program suitable for undergraduate law students. These observations form the basis of an overall model that may be adapted for use in the teaching of other law subjects, not just taxation.

**EXPLORING THE IMPACT OF STUDENTS' LEARNING STYLE ON  
PERFORMANCE IN TAXATION**

LIN MEI TAN and FAWZI LASWAD\*

**ABSTRACT**

The findings of various studies regarding the association between students' learning style and academic performance are inconclusive. This study examines the association between learning style preferences and performance of students in an undergraduate taxation course at a large New Zealand university. An instrument based on Kolb's Learning Style Inventory was used to profile the learning styles of students as one of four learning groups: Converging, Diverging, Assimilating or Accommodating. The results indicated that the majority of the students were either Convergents or Assimilators and there were no significant differences in performance between the two learning style groups. These results suggest that as more and more educators adopt various approaches in teaching and engaging students in learning, tertiary students have the ability to adapt to different learning styles. Educators can certainly help students to learn by exposing them to varied learning styles.

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## I INTRODUCTION

Students enrolled in tertiary education have widely diverse backgrounds, including their cultural, life and work experiences, age, gender, attitudes, and intellectual abilities. This diversity brings with it diverse learning styles.

Learning style is the “composite of characteristic cognitive, affective, and psychological factors that serves as an indicator of how an individual interacts with and responds to the learning environment”.<sup>1</sup> Therefore, a person’s learning style is his or her preferred way of learning and different individuals have different learning styles or certain learning orientations.<sup>2</sup> If students have a preference for a particular learning style, the effectiveness of any learning activities can be strongly influenced by that style of learning.<sup>3</sup> For instance, some may prefer to work with concrete information (eg, facts, experimental data) while others are more comfortable with abstractions (eg, theories, symbolic information, mathematical models). Some are partial to visual presentation of information (eg, pictures, diagrams, flowcharts, schematics) while others prefer verbal explanations. In other words, some like to learn by trying things out and seeing and analysing what happens, and others would rather reflect on things they plan to do and understand as much as they can about them before actually attempting them. When the learning styles of students in a class and the teaching style of their teacher are seriously mismatched, those students may become uncomfortable, bored, and inattentive in class.<sup>4</sup> As a consequence, they may lose interest in the course, the curriculum and themselves, and in some cases may change to other courses or drop out of studies altogether.<sup>5</sup> If learning styles affect students’ academic performance and competence, then it certainly poses further challenges for educators in assisting students in learning and succeeding academically.

There are numerous learning style models and instruments used for assessing students’ learning preferences. Kolb’s<sup>6</sup> experiential learning model is one that is well established and widely used by researchers. This model identifies four learning styles:

1. Converging (those who like to think and do; take in information abstractly and then process the information actively);
2. Diverging (those who like to feel and watch; take in information concretely and process the information reflectively);
3. Assimilating (those who like to think and watch; more concerned with abstract concepts and process information reflectively); and
4. Accommodating (those who like to feel and do; takes in information concretely and process the information actively).

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<sup>1</sup> Angus Duff, ‘A Note on the Psychometric Properties of the Learning Style Questionnaires (LSQ)’ (2001) 10 *Accounting Education* 185, 185.

<sup>2</sup> Peter Honey and Alan Mumford, *The Manual of Learning Style* (Maidenhead, 1992).

<sup>3</sup> Honey and Mumford, above n 2.

<sup>4</sup> Noel Entwistle, *Styles of Learning and Teaching* (Fulton, 1988).

<sup>5</sup> Richard Felder and Joni Spurling, ‘Applications, Reliability, and Validity of the Index of Learning Styles’ (2005) 21 *International Journal of Engineering Education* 103.

<sup>6</sup> David Kolb, *Learning Style Inventory: Technical Manual* (McBer & Co., 1976).

Studies that examined the learning styles of accounting or business students using Kolb's Learning Style Inventory produced interesting results. Earlier studies tended to show that accounting students predominantly displayed a Converging learning style.<sup>7</sup> However, some more recent studies<sup>8</sup> suggest that this Converging style may not be as universally applicable to accounting students as once thought, as studies have shown that accounting students are also Assimilators.<sup>9</sup>

Interestingly, studies which examined the effect of learning styles on students' performance or achievement showed diverse results and not many studies have focused on the association between learning style and students' performance in the accounting discipline. Some studies which examined this aspect found that students with the Converging learning style were more successful.<sup>10</sup> In contrast, Geiger, Boyle and Pinto<sup>11</sup> found students' learning style had no significant effect on final grades. Only one study<sup>12</sup> considered students' performance in a taxation course. Although Too<sup>13</sup> found that students enrolled in a taxation course were mainly Convergents, there was no significant association between their learning styles and performance in the final exam.

Taxation is one of the many subjects required in most accounting degrees at both undergraduate and postgraduate levels. It is a subject that requires interpretation and application of tax rules and regulations, and students usually find it challenging as tax law is complex and voluminous, replete with conditions and exceptions, constantly changing, and is interrelated with other areas of law. It is therefore interesting to

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<sup>7</sup> See Bruce Baldwin and Philip Reckers, 'Exploring the Role of Learning Style Research in Accounting Education Policy' (1984) 2 *Journal of Accounting Education* 63; and Richard Baker, John Simon and Frank Bazeli, 'An Assessment of the Learning Style Preferences of Accounting Majors' (1986) 1 *Issues in Accounting Education* 1.

<sup>8</sup> See, eg, Thomas McKee, Theodore Mock and T Flemming Ruud, 'A Comparison of Norwegian and United States Accounting Students' Learning Style Preferences' (1992) 1 *Accounting Education* 321; Joyce Holley and Elizabeth Jenkins, 'The Relationship Between Student Learning Style and Performance on Various Test Question Formats' (1993) 68 *Journal of Education for Business* 301; Pak Auyeung and John Sands, 'A Cross-Cultural Study of the Learning Style of Accounting Students' (1996) 36 *Accounting and Finance* 261; Robert Loo, 'The Distribution of Learning Styles and Types for Hard and Soft Business Majors' (2002) 22 *Educational Psychology* 349; Pru Marriott, 'A Longitudinal Study of Undergraduate Accounting Students' Learning Style Preferences at Two UK Universities' (2002) 11 *Accounting Education* 43; LChung and BHu, 'Learning Style, Major and Performance: An Exploratory Study' (Paper presented at the AFAANZ Conference, Australia, 2003); Kate Wynn-Williams, Rosalind Whiting and Ralph Adler, 'The Influence of Business Case Studies on Learning Styles: An Empirical Investigation' (2008) 17 *Accounting Education* 113; and Satoshi Sugahara and Gregory Boland, 'The Role of Cultural Factors in the Learning Style Preferences of Accounting Students: A Comparative Study Between Japan and Australia' (2010) 19 *Accounting Education* 235.

<sup>9</sup> Ralph Adler, Rosalind Whiting and Kate Wynn-Williams, 'Student-led and Teacher-led Case Presentations: Empirical Evidence about Learning Styles in an Accounting Course' (2004) 13 *Accounting Education: An International Journal* 213.

<sup>10</sup> See, eg, Dennis Togo and Bruce Baldwin, 'Learning Style: A Determinant of Student Performance for the Introductory Financial Accounting Course' (1990) 8 *Advances in Accounting* 189; Holley and Jenkins, above n 8; F Cano-Garcia and Elaine Hughes, 'Learning and Thinking Styles: An Analysis of Their Interrelationship and Influence on Academic Achievement' (2000) 20 *Educational Psychology* 413; and Adler et al, above n 9.

<sup>11</sup> Marshall Geiger, Edmund Boyle and Jeffrey Pinto, 'An Examination of Ipsative and Normative Versions of Kolb's Revised Learning Style Inventory' (1993) 53 *Educational and Psychological Measurement* 717.

<sup>12</sup> Shaw Too, *Students' Learning Style and their Academic Achievement for Taxation Course - A Comparison Study*, (Paper presented at the 2nd International Conference of Teaching and Learning, Malaysia, 2009).

<sup>13</sup> Above n 12.

examine whether students' learning style impacts on their learning outcomes in a taxation course. This study extends prior research by exploring the learning styles of accounting students enrolled in a compulsory introductory taxation course in the second year of an undergraduate accounting degree in a multi-campus university in New Zealand. The students' performance in this course was considerably lower than other accounting and business courses for the past few years. As a result, it has led us to question the extent to which these students' learning styles may have impacted on their performance in the taxation course. The taxation course in this university is designed to focus on tax concepts and principles and not the mere memorisation of tax rules. Learning and understanding the tax concepts and principles is very important as students need a sound understanding of the tax law to be able to apply it when faced with a tax problem. Studying taxation, therefore, may present problems and challenges to students who are studying it for the first time, particularly if they have certain learning preferences. To assess each student's learning style, we adopted the Kolb Learning Style Inventory (LSI) as it is one of the instruments most commonly used by other researchers.<sup>14</sup>

The remainder of the paper is structured in the following manner. Section 2 provides an overview of the literature on learning styles. In Section 3, the research method and the learning styles questionnaire are discussed. Section 4 presents the results. The last section provides the discussion and conclusion.

## II LITERATURE REVIEW

### *A Learning Styles*

There is no universal definition of learning style as the concept has been defined in different ways in the literature. However, there is consensus that every person has a learning style preference.<sup>15</sup> The four broad elements that have been attributed to learning style are: (i) 'cognitive personality elements' such as field dependence and independence;<sup>16</sup> (ii) 'information-processing style' such as Kolb's model of the experiential learning cycle,<sup>17</sup> and the associated learning styles (Converger, Diverger, Accommodator, Assimilator) or the related learning styles suggested by Honey and Mumford<sup>18</sup> (ie, Activist style, Reflector style, Theorist style and Pragmatist style); (iii) 'approaches to studying'<sup>19</sup> which, in terms of function and process, may lie somewhere in between 'cognitive personality elements' and 'instructional preferences'; and (iv)

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<sup>14</sup> See Adler et al, above n 9; and Thomas Hawk and Amit Shah, 'Using Learning Style Instruments to Enhance Student Learning' (2007) 5 *Decision Sciences: Journal of Innovative Education* 1.

<sup>15</sup> Angus Duff, 'Validating the Learning Styles Questionnaire and Inventory of Learning Process in Accounting: A Research Note' (1997) 6 *Accounting Education: An International Journal* 263.

<sup>16</sup> See, eg, H Witkin et al, 'Field-Dependent and Field-Independent Cognitive Styles and Their Educational Implications' (1997) 47 *Review of Educational Research* 1; and Richard Riding, *Cognitive Styles Analysis* (Learning and Training Technology, 1997).

<sup>17</sup> David Kolb, *Experiential Learning: Experience as the Source of Learning and Development* (Prentice Hall, 1984).

<sup>18</sup> See Honey and Mumford, above n 2.

<sup>19</sup> See, eg, F Marton and R Saljo, 'On Qualitative Differences in Learning I: Outcome as a Function of the Learners' Conception of the Task' (1976) 46 *British Journal of Educational Psychology* 4; and Noel Entwistle and Hilary Tait, *The Revised Approaches to Studying Inventory*, (Centre for Research into Learning and Instruction, University of Edinburgh, 1994).

'instructional preferences' such as those measured by inventories like the Grasha-Riechmann Student Learning Styles Scales.<sup>20</sup>

Learning style is, therefore, a learner characteristic and students have different learning style characteristics of which they may not be aware.<sup>21</sup> Knowledge about students' learning styles, particularly early in their academic career can benefit both students and teachers.<sup>22</sup> For students, it would help them to understand their own strengths and weaknesses and consequently to learn more effectively and take responsibility for their own learning.<sup>23</sup> For teachers, it may help them consider appropriate teaching strategies to enhance students' learning strengths. Their awareness of students' learning styles would help them in making informed choices in course material, design and learning processes to extend the opportunity for effective learning in their courses.<sup>24</sup> Research shows that students learn better when new material is presented in a way that is compatible with their learning style.<sup>25</sup>

Individual learning styles may also differ according to subject areas, and styles may change as individuals become more competent, confident and mature with the content material of the subject.<sup>26</sup> Dunn<sup>27</sup> notes that although style preferences may change with maturation, strong preferences may take years to change.

In summary, the literature suggests that:

- students will learn better when they use learning styles which they prefer;
- when teaching accommodates various learning preferences, more students are likely to be successful; and
- students are better learners when they can expand their learning preferences.

### ***B Kolb's Learning Style Measurement Instruments***

A number of measurement instruments were used to identify individual learning styles. They include: the VARK<sup>28</sup> Model,<sup>29</sup> the Index of Learning Styles (ILS),<sup>30</sup> the Learning

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<sup>20</sup> S Hruska-Riechmann and A Grasha, 'The Grasha-Riechmann Student Learning Style Scales: Research Findings and Applications' in J Keefe (ed), *Student Learning Styles and Brain Behavior* (NASSP, 1982).

<sup>21</sup> Katherine Rogers, 'A Preliminary Investigation and Analysis of Student Learning Style Preferences in Further and Higher Education' (2009) 33 *Journal of Further and Higher Education* 13-21.

<sup>22</sup> George Brown and Madeleine Atkins, *Effective Teaching in Higher Education* (Routledge, 1996).

<sup>23</sup> See, eg, Honey and Mumford, above n 1; and Rogers, above n 21.

<sup>24</sup> See Hawk and Shah, above n 14, 2.

<sup>25</sup> Rita Dunn, 'Understanding the Dunn and Dunn Learning Styles Model and the Need for Individual Diagnosis and Prescription' (1990) 6 *Journal of Reading, Writing and Learning Disabilities International* 223.

<sup>26</sup> Josie Misko, *Flexible Delivery: Will a Client Focus System Mean Better Learning?* (National Centre for Vocational Education Research, 1994) 40; and Pru Marriot, 'A Longitudinal Study of Undergraduate Students' Learning Style Preferences at Two UK Universities' (2010) 11 *Accounting Education* 43.

<sup>27</sup> Above n 25.

<sup>28</sup> VARK stands for visual, aural, read/write and kinaesthetic.

<sup>29</sup> Neil Fleming, *Teaching and Learning Styles: VARK Strategies* (N.D. Fleming, 2001).

<sup>30</sup> Richard Felder and Linda Silverman, 'Learning Styles and Teaching Styles in Engineering Education' (1988) 78 *Engineering Education* 674.



Style Inventory (LSI),<sup>31</sup> the Learning Style Questionnaire (LSQ),<sup>32</sup> and the Approaches to Studying Inventory (ASI).<sup>33</sup> These different learning models have their strengths and weaknesses and no one instrument captures all of the richness of the phenomenon of learning style.<sup>34</sup> However, Kolb's LSI,<sup>35</sup> based on experiential learning theory, is widely used.<sup>36</sup>

The LSI has been considered as an instrument that would give the most valid and reliable coverage of student learning styles and approaches to learning.<sup>37</sup> This experiential model defines learning as "the process whereby knowledge is created through the transformation of experience".<sup>38</sup> Kolb describes learning style within a two-factor model which combines how people perceive and process information. He defines learning style as the "generalised differences in learning orientation based on the degree to which people emphasise the four modes of the learning process".<sup>39</sup>

Figure 1 depicts Kolb's model. This model views learning as a circular process which involves a four-mode or four-process learning cycle. It starts with Concrete Experience (CE) which forms the basis for observation and reflection on experiences. Reflective Observation (RO) then leads to Abstract Conceptualisation (AC), which involves the generation of theories/ solutions to the problem set and finally, to Active Experimentation (AE), where theories and concepts are put into practice. Kolb<sup>40</sup> noted that the most effective and complete learning takes place when learning activities embrace all four modes. However, depending on the individual's preferences, learning may start at any one of the four modes in the cycle. Kolb describes CE and AC as bipolar on a continuum, and orthogonal to a second bipolar continuum of RO and AE. Individual learning styles result from a combination of two adjacent mode preferences in the experiential learning cycle leading to four basic learning styles: Diverger (CE and RO), Assimilator (RO and AC), Converger (AC and AE), and Accommodator (AE and CE).

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<sup>31</sup> David A Kolb, *LSI Learning-Style Inventory* (McBer & Co, 1985).

<sup>32</sup> Honey and Mumford, above n 2.

<sup>33</sup> Noel Entwistle and Paul Ramsden, *Understanding Student Learning* (Croom Helm, 1983).

<sup>34</sup> Hawk and Shah, above n 14.

<sup>35</sup> The LSI was first developed by Kolb in 1971 (LSI 1) and revised in 1985 (LSI 2), in 1993 (LSI 2a), in 1999 (LSI 3) and then in 2005 (LSI 3.1) to improve the instrument's validity and reliability. All versions of the LSI had the same format – short questionnaire with 12 items (only the LSI 1 had nine items).

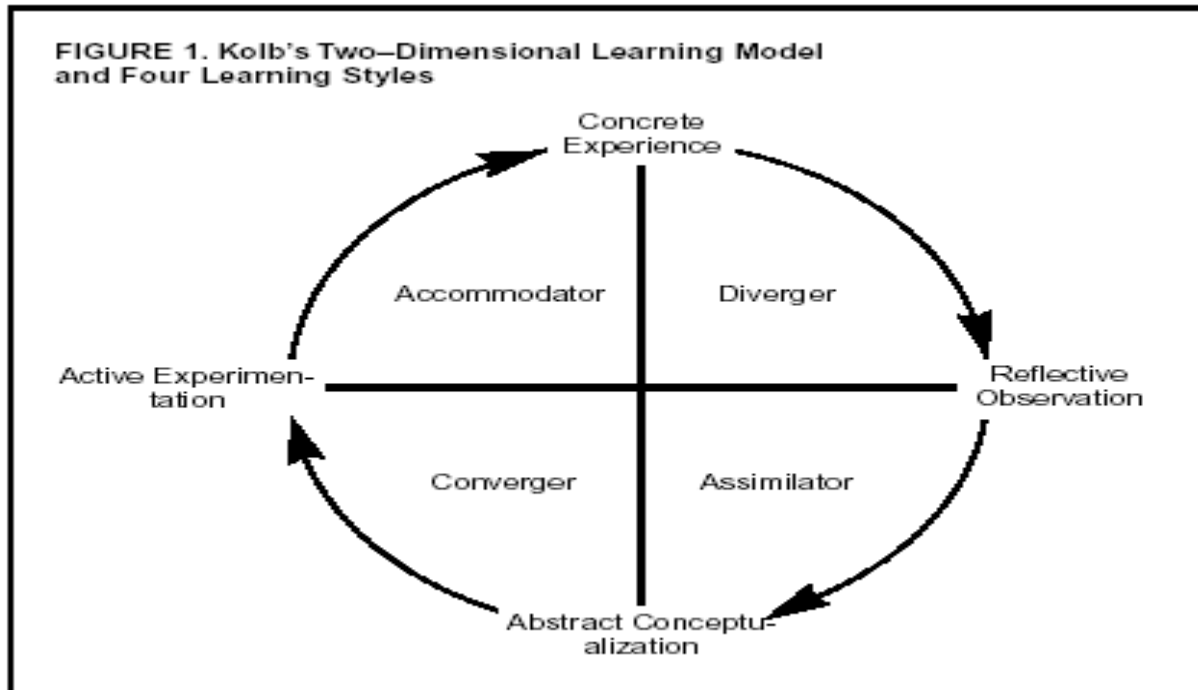
<sup>36</sup> Richard Wilson and Andrew Hill, 'Learning Styles – A Literature Guide' (1994) 4 *Accounting Education* 349; ADuff, 'A Note on the Problem Solving Style Questionnaire: An Alternative to Kolb's Learning Style Inventory?' (2004) 24 *Educational Psychology* 699; and Sugahara and Boland, above n 8.

<sup>37</sup> Hawk and Shah, above n 14.

<sup>38</sup> Kolb, above n 6, 41.

<sup>39</sup> *Ibid* 76.

<sup>40</sup> Above n 6.



Source: Michael Seda, 'Innovative Strategies for Teaching Principles of Accounting and Federal Taxation Classes' (2004) 1 *Journal of College Teaching and Learning* 41, 42.

The Divergers are best at viewing concrete situations from different points of view, and tend to be imaginative and emotional, and like to generate ideas. Such learners have broad cultural interests and tend to specialise in the arts, counselling, and personnel management. People with the diverging style prefer to work in groups, enjoy brainstorming within a group, listen with an open mind, and prefer to receive personal feedback.

The Assimilators tend to be less interested in people and more concerned with abstract concepts. They are best at putting information into a logical and detailed form. In a formal learning situation, people with this style prefer reading, lectures, exploring analytical models and having time to think things through. People who prefer the assimilating learning style would not be comfortable being thrown in the deep end without notes and instructions. With these orientations, they are more interested in basic sciences and mathematics rather than the applied sciences.

The Convergers are best at finding practical uses for ideas and theories, tend to use hypothetical-deductive reasoning to solve specific problems, and prefer to deal with things rather than people. People with a converging style like to experiment with new ideas to stimulate and to work with practical applications. Such learners are often found in specialist and technology careers such as the engineering professions as well as the accounting profession.

The Accommodators are "hands-on" and rely on intuition and information from other people rather than books and lectures. They commonly act on "gut" instinct rather than logical analysis. People with the Accommodating learning style prefer to work in teams

to complete tasks. They are likely to become frustrated if they are forced to follow many instructions and rules, and are unable to get hands-on experience as soon as possible.

Earlier studies provided empirical evidence of accounting students and accounting practitioners predominantly displaying the Converging learning style.<sup>41</sup> The majority of senior accounting students (40%) in Baker, Simon and Bazeli's<sup>42</sup> US study were found to be Convergents with another 20% being Assimilators. Baldwin and Reckers<sup>43</sup> found that introductory accounting students (who intended to major in accounting) were primarily Assimilators whereas accounting students at higher levels tended to be Convergents. Consistent with these results were the findings of Brown and Burke,<sup>44</sup> and Gow, Kembar and Cooper,<sup>45</sup> which show that this Converging learning style becomes more deeply ingrained as undergraduate accounting students progress through their studies. It is also the predominant learning style found in lower and middle level accountants.<sup>46</sup> However, some recent studies<sup>47</sup> suggest that this Converger style may not be as universally applicable to accounting students as once thought.<sup>48</sup> Loo<sup>49</sup> for instance found undergraduate on-campus accounting major students in Canada tended to be Assimilators. A US study conducted by Novin, Arjomand and Jourdan<sup>50</sup> found 47% of undergraduate on-campus accounting students were Convergents and 38% were Assimilators.

Seda<sup>51</sup> found that the majority of the undergraduate accounting students in his US study were Assimilators (43%). However, a Malaysian study by Too<sup>52</sup> indicated that the

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<sup>41</sup> Baldwin and Reckers, above n 7, used sophomore, junior and senior accounting students at a large public university in the US; Baker, Simon and Bazeli, above n 7, used 110 senior accounting students; H Brown and Richard Burke, 'Accounting Education: A Learning Styles Study of Professional Technical and Future Adaptation Issues' (1987) 5 *Journal of Accounting Education* 187, used 583 Canadian accounting students and 146 accounting professionals; and Julie Collins and Valerie Milliron, 'A Measure of Professional Accountants' Learning Style' (1987) 2 *Issues in Accounting Education* 193, used 334 accounting practitioners and no students.

<sup>42</sup> Above n 7. Their sample consisted of 110 senior accounting major students enrolled at one US university.

<sup>43</sup> Above n 7.

<sup>44</sup> Above n 41. Their sample consisted of undergraduate business students (n=674) and accounting graduates (n=359) at one university in Canada. Their response rate was 42%.

<sup>45</sup> Lyn Gow, David Kembar and Barry Cooper, 'The Teaching Context and Approaches to Study of Accountancy Students' (1994) 9 *Issues in Accounting Education* 118. Their sample consisted of 793 students enrolled in degree-level courses in accountancy and other academic departments at Hong Kong Polytechnic. The survey was conducted during class time and generated a response rate of 80%.

<sup>46</sup> Brown and Burke, above n 41.

<sup>47</sup> See, eg, Holley and Jenkins, above n 8; Loo, above n 8; Marriott, above n 8; Adel Novin, Lari Arjomand and Louis Jourdan, 'An Investigation into the Preferred Learning Styles of Accounting, Management, Marketing and General Business Majors' (2003) 18 *Teaching and Learning* 24; and Chung and Hu, above n 8.

<sup>48</sup> Adler, Whiting and Wynn-Williams, above n 9.

<sup>49</sup> Above n 8. Loo's sample consisted of 437 undergraduate business major students at a small Canadian liberal-education university.

<sup>50</sup> Above n 47. Their sample consisted of 274 undergraduate business students at a state university in the US.

<sup>51</sup> Michael Seda, 'Innovative Strategies for Teaching Principles of Accounting and Federal Taxation Classes' (2004) 1 *Journal of College Teaching and Learning* 41. Seda's sample consisted of 108 undergraduate students at one US university composed of four subgroups: students enrolled in Accounting Principles 1: morning class, afternoon class and evening class, and in the Federal Income

learning styles of undergraduate students enrolled in the taxation course are Converger dominant. These latter studies suggest that accounting students have a wider variety of learning styles, with the Assimilator and Accommodator styles being often equally as pervasive as the Converger style.<sup>53</sup>

An important point to note when making comparisons between studies is the composition of the sample used. In some studies mixed groups were used (eg, fourth year students and graduate students, etc) while in others only single groups were used (eg, only introductory accounting students).

The literature suggests that learning style preference is influenced by particular factors such as personality type, career choice, current job, current task, and culture. As Kolb<sup>54</sup> pointed out, many factors helped shape a student's current learning style and will continue to shape it, perhaps in different directions. Studies in other disciplines have examined the effect of various factors such as personality, culture, course context and demographic profile on learning styles. In the accounting discipline, there are many studies investigating the link between culture and learning styles of accounting students, and these studies show consistent findings for this link more than any other factor. For example, McKee, Mock and Ruud<sup>55</sup> showed that Norwegian accounting students tended to be Assimilators whereas accounting students in the US were more likely to be Convergents. Auyeng and Sands<sup>56</sup> showed that Australian students exhibited an Accommodating learning style, whereas students from Hong Kong and Taiwan displayed an Assimilator style. A more recent study by Sugahara and Boland<sup>57</sup> indicated culture has an impact on learning styles, finding that the learning styles of Australian accounting students is Assimilating, but Diverging for Japanese accounting students. These findings suggest that educators should consider ways to bridge the gap between students' learning preferences and teachers' teaching styles in multicultural classrooms where international students may be simultaneously seeking to overcome culture-shock or language-related barriers.<sup>58</sup>

Other studies suggest that student approaches to learning can be modified as they are exposed to different teaching approaches, learning outcomes, teaching contexts, and modes of assessment.<sup>59</sup> Further, Biggs<sup>60</sup> noted that approaches to learning are also

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Taxation evening class. Data was collected during the first two weeks of classes. No response rate was reported but we assume that all 108 students responded.

<sup>52</sup> Above n 12. Too used final year students enrolled in an accounting program with a Malaysian private higher education institution.

<sup>53</sup> Wynn-Williams, Whiting and Adler, above n 8.

<sup>54</sup> Above n 6.

<sup>55</sup> Above n 8.

<sup>56</sup> Above n 8.

<sup>57</sup> Above n 8.

<sup>58</sup> Glauco De Vita, 'Learning Styles, Culture and Inclusive Instruction in the Multicultural Classroom: A Business and Management Perspective' (2001) 38 *Innovations in Education and Teaching International* 165.

<sup>59</sup> Ronald Schmeck, 'Learning Styles of College Students' in Ronna Dillon and Ronald Schmeck (eds), *Individual Differences in Cognition* (Academic Press, 1983) 233; Kolb, above n 17; JBiggs, 'Student Learning Research and Theory: Where do we currently stand?' in Graham Gibbs (ed) *Improving Student Learning: Theory and Practice* (Oxford Centre for Staff Development, 1994) 1; and Marriott, above n 8.

<sup>60</sup> Above n 59, 11.

sensitive to teaching contexts. For instance, changes in the accounting curriculum to reflect the competencies required of today's accountants may influence students' learning styles. Indeed, a study of accounting students in the UK<sup>61</sup> showed a shift away from Converger prevalence to the dominance of the Accommodator learning style. Marriott<sup>62</sup> argued that this learning style is well suited to the demands of accountants' work today, as Accommodators tend to be practical, technical and good at executing plans, and they display risk-taking behaviour, leadership and intuitive problem-solving skills. However, Duff<sup>63</sup> and Busato et al<sup>64</sup> found little change in students' learning style over time. Adler, Whiting and Wynn-Williams'<sup>65</sup> work on the effect of case studies found that there was a move away from Accommodators and Divergers toward Assimilators.

### ***C Learning Style and Performance***

There are fewer studies that have examined the possible link between learning styles of undergraduate accounting students and performance in accounting courses. However, the findings were not consistent. Some studies showed that accounting students with the Converging learning style were more successful particularly in multiple choice tests.<sup>66</sup> For example, Holley and Jenkins<sup>67</sup> found that there was a significant relationship between learning styles and performance on each examination format except for the multiple-choice quantitative format. Their study indicates that students with the AC learning mode performed better in open-ended theory questions compared to students with the CE learning mode. Further, the AE learning mode was positively associated with performance in open-ended quantitative questions as compared to the RO learning mode. In contrast, Geiger, Boyle and Pinto<sup>68</sup> found no significant effect of students' learning style on their final grades. This is consistent with the finding by Too<sup>69</sup> of no significant association between learning styles of students and their performance in the final examination.

Although numerous studies have focused on the association between learning style and students' performance in other disciplines, there is a dearth of research in the tax discipline in particular. In this study, we explore the learning styles of students enrolled in an undergraduate taxation course and we pose the following research questions: What are the students' learning styles? Does learning style impact on students' performance in assessments and examinations and their final results? Do mode of education (on-campus or off-campus), age, gender and cultural origin play a role in predicting students' performance?

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<sup>61</sup> Marriott, above n 8.

<sup>62</sup> Above n 8.

<sup>63</sup> Aove n 15.

<sup>64</sup> Vittorio Busato, Frans Prins, Jan Elshout and Christiaan Hamaker, 'The Relation Between Learning Styles, The Big Five Personality Traits and Achievement Motivation in Higher Education' (1998) 26 *Personality and Individual Differences* 129.

<sup>65</sup> Above n 9.

<sup>66</sup> See Togo and Baldwin, above n 10, their sample consisted of introductory accounting students; Holley and Jenkins, above n 8; and Cano-Garcia and Hughes, above n 10.

<sup>67</sup> Above n 8.

<sup>68</sup> Above n 11.

<sup>69</sup> Above n 12.

### **III RESEARCH METHOD**

#### ***A Data Collection***

The data collection was conducted during the first few weeks of the second semester of the academic year in which the course was offered. The instrument was placed on-line via a link on the taxation course learning website with an invitation to students to voluntarily participate in the survey. An information sheet with an example was provided to guide students in how to respond to survey questions. The examples used in the information sheet were hypothetical and different from the questions in the instrument to ensure no influence or bias was introduced. To encourage participation, students were offered the opportunity to receive feedback on their individual learning style preferences. Students were assured that their responses would remain confidential. Demographic information regarding their mode of education (on-campus or off-campus), age, gender and cultural origin was also collected.

#### ***B Student Sample and Assessments***

The introductory taxation course is students' first course in tax and is designed to introduce them to the principles of New Zealand taxation. The learning course has three outcomes:

- Explain and discuss the various types of taxation and tax bases applicable in New Zealand and the potential implications for a New Zealand entity operating in the global environment.
- Demonstrate an understanding of the tax concepts that govern the determination of tax obligations relating to various personal and business structures.
- Demonstrate an understanding of tax as an instrument of fiscal policy.

This course had three separate assessments, one of which was a final examination. The weighting of the first two assessments together was 30% and the final examination 70%. The first assessment (Assessment 1) comprised multiple choice type questions with justification of answers. This assessment was set in such a way so that students who only guessed the correct answers would not receive full marks. Therefore, it provided a better assessment of students' understanding of content material and also "forced" students to learn how to defend their answers. The second assessment (Assessment 2) required students to provide short answers to various tax issues over a number of questions. The purpose of setting the assignment in this manner was to assess students' understanding of the concepts and principles of tax and their ability to apply them to various tax scenarios and contexts. The format of the final examination used both multiple choice questions with justifications, and several short answer type questions. With these types of assessments, students would not perform well if they merely adopt a "surface learning" approach.<sup>70</sup>

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<sup>70</sup> Those who use surface learning adopt strategies that focus on factual acquisition, rote memorization and they treat parts of the subject as separate entities, failing to integrate topics into a coherent whole (see Entwistle and Ramsden, above n 33).



### ***C Instrument***

Students' learning styles were profiled using the third version of Kolb's Learning-Style Inventory (LSI).<sup>71</sup> The Kolb LSI is a commercially available questionnaire and consists of 12 items where respondents rank-order (from most likely to least likely) four sentence endings that correspond to the four learning modes, with scores between 12 and 48. This study used the third version (3.1) and the 12 items are set out in the following manner. Each item contains four words or phrases that the respondent is required to rank-order according to how well the word or phrase describes his or her learning style. For instance, one item asks, 'I learn by' and then is followed by the following four words, 'feeling', 'doing', 'watching' and 'thinking'. High rank orders given to 'feeling' correspond with a preference for concrete experience (CE), while high rank orders for 'doing', 'watching', and 'thinking' correspond with 'active experimentation' (AE), 'reflective observation' (RO), and 'abstract conceptualization' (AC), respectively. Students' responses were scored on each of these four learning modes and on two learning styles as defined by Kolb.<sup>72</sup> These two learning styles illustrate the preference a learner has, first for acquiring the information, and secondly for transforming the information.

The information acquisition preference is determined by subtracting the respondent's concrete experience (CE) score from his or her abstract conceptualization score (AC). Meanwhile, the respondent's preference for information transformation is determined by subtracting his or her reflective observation (RO) scores from his or her active experimentation (AE) score. The individual's AC-CE scores are placed against their AE-RO scores on a Learning Style Type grid which indicates their preferred learning style.

### **IV RESULTS**

Fifty-eight students responded voluntarily giving a response rate of about 11%.<sup>73</sup> Seven responses were invalid which resulted in 51 usable responses. The low response rate could be attributed to students feeling that there were not sufficient incentives to participate or that the instrument was complex and too time consuming to complete. Our sample is larger than that of Marriot<sup>74</sup>, which was made up of 32 students in a UK university, but slightly smaller than Sugahara and Boland<sup>75</sup> which had 61 responses (response rate 21%) for an Australian sample.

Table 1 describes the study sample. There was a balance in responses between on-campus and off-campus students. The students' age varied, with the youngest at 18 years and the oldest at 51 years. About 18% of students were under 21 years of age whereas the majority (82%) were over 20 years of age. This profile is not surprising as

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<sup>71</sup> Permission was given to use the LSI by the LSI Research Committee in 2010. The third version randomises the scoring items and improves the test-retest reliability (see David Kolb and Alice Kolb, *The Kolb Learning Style Inventory – Version 3.1 2005 Technical Specifications* (Hey Group, 2005)).

<sup>72</sup> Above n 17.

<sup>73</sup> There were about 515 students enrolled in the taxation course on the three campuses and in distance learning at the start of the semester, but usually the number drops as the weeks go by, especially for the distance learning students who find they cannot cope with their studies.

<sup>74</sup> Pru Marriot, 'A Longitudinal Study of Undergraduate Accounting Students' Learning Style Preferences at two UK Universities' (2002) 11 *Accounting Education* 43-62.

<sup>75</sup> Above n 8.

most off-campus students were mature (older) students and in employment. Respondents were predominantly domestic students and female

Table 1: Respondents' profile

	No.	%
Mode of study:		
On-campus		
Off-campus	22	43
	<u>29</u>	<u>57</u>
	<u>51</u>	<u>100%</u>
Age:		
Under 21 years		
21-30 years	9	18
Above 30 years	19	37
	<u>23</u>	<u>45</u>
	<u>51</u>	<u>100%</u>
Domestic/International:		
Domestic student		
International student	48	94
	<u>3</u>	<u>6</u>
	<u>51</u>	<u>100%</u>
Gender:		
Female		
Male	43	84
	<u>8</u>	<u>16</u>
	<u>51</u>	<u>100%</u>

### *A Students' Learning Style*

Table 2 shows the mean scores on each component of the two major learning dimensions. The lowest raw score is 13 and the highest is 47. The vast majority of participants preferred abstract conceptualization (AC) over concrete experience (CE), and active experimentation (AE) over reflective observation (RO).

Table 2: Descriptive statistics

	No.	Minimum	Maximum	Mean	Std. Deviation
AC total	51	24	47	35.84	6.12
CE Total	51	13	32	20.20	3.99
AE total	51	17	46	36.33	6.65
RO total	51	16	47	27.80	5.82
AC-CE	51	1	30	15.65	7.19
AE-RO	51	-20	27	8.53	10.04

Table 3 shows the distribution of the four learning style preferences in the sample which indicates that there were two predominant learning styles. Most students (57%) preferred a Converging learning style, followed by 35% who preferred an Assimilating learning style. Only one student was a Diverger and three students were Accommodators. This result is consistent with more recent studies showing accounting students tend to be Convergers or Assimilators.

Table 3: Student learning style preferences

Learning style	No.	%
Accommodating	3	6
Assimilating	17	35
Converging	28	57
Diverging	<u>1</u>	<u>2</u>
Total	<u>49*</u>	<u>100</u>

*\*Two students who participated in the survey later withdrew from the course*

Table 4 shows the profile of students by each learning style and includes the study mode and students' age.<sup>76</sup> Comparing the four groups, the Assimilators had the lowest mean age and the Divergers had the highest. The majority (65%) of Assimilators were on-campus students whereas the majority (71%) of Convergers were off-campus students. Off-campus students are typically older and have some experience in comparison with on-campus students and this factor may have influenced learning style.

Table 4: Profile of student learning style preferences

	Accommodating		Assimilating		Converging		Diverging	
	No.	%	No.	%	No.	%	No.	%
Study Mode:								
On campus	1	33	11	65	8	29	1	100
Off campus	<u>2</u>	<u>67</u>	<u>6</u>	<u>35</u>	<u>20</u>	<u>71</u>	<u>0</u>	<u>0</u>
	<u>3</u>	<u>100</u>	<u>17</u>	<u>100</u>	<u>28</u>	<u>100</u>	<u>1</u>	<u>100</u>
Gender:								
Female	2	67	14	82	24	86	1	100
Male	<u>1</u>	<u>33</u>	<u>3</u>	<u>18</u>	<u>4</u>	<u>14</u>	<u>0</u>	<u>0</u>
	<u>3</u>	<u>100</u>	<u>17</u>	<u>100</u>	<u>28</u>	<u>100</u>	<u>1</u>	<u>100</u>
Age:								
Mean (SD)	30 (7.81)		28 (9.55)		32 (9.93)		51	
Range	25-39		18-49		18-55		51	

<sup>76</sup> Breakdowns for gender and domestic/international students are not shown as the numbers for male students and international students were very small compared to female and domestic students respectively.

### **B Students' Performance**

Table 5 shows that the highest score in all assessments was achieved by the only student with a Diverging learning style. Background information shows that this participant is a 51 year old domestic student. In comparison, the Accommodators had the lowest mean score in all three types of assessments. Perhaps this is not surprising as Accommodators do not like many instructions and rules such as those found in a subject like taxation. However, as the number of students that fell into these two learning preferences was extremely small, any findings may not be subject to generalisation. The remaining analysis is focused on the Assimilators and the Convergengers.

Overall, the Convergengers appear to have performed better than the Assimilators in the first assessment and the final exam, but the Assimilators performed better in the second assessment. As the nature of the first assessment is different from the second assessment, this may suggest that the performance of students with particular learning styles is influenced by the nature of the assessment.

**Table 5: Assessment scores**

Learning Style	Assessment 1		Assessment 2		Exam	
	Mean	SD	Mean	SD	Mean	SD
Accommodating (n=2-3)*	64.72	4.36	61.00	6.08	51.00	12.02
Assimilating (n=17)	65.45	12.64	73.29	10.37	59.15	11.59
Converging (n=27-28)*	67.99	15.33	67.39	17.74	61.24	18.08
Diverging (n=1)	80.56	0	82.00	0	65.50	0

*\*One student did not sit the final exam*

Table 6 shows a comparison of performance between the Convergengers and Assimilators that indicates there were no significant differences in assessment 1, assessment 2 and final exam scores for those with converging and assimilating learning styles. Specifically, the results suggest that students' performances were not influenced by their learning styles.<sup>77</sup>

<sup>77</sup> Further analysis also showed that there were no significant differences in performance in the three types of assessments between on-campus and off-campus students.

Table 6: *T*-test results of comparing the performance of Convergers' and Assimilators' learning styles

	F	T	df	Sig. (2-tailed)	Std. Error Difference
Assessment 1	.302	.576	43	.568	4.424
Assessment 2	3.233	-1.245	43	.220	4.739
Exam	5.883	.468	41.965	.642	4.473

## V DISCUSSION AND CONCLUSION

This study examined the learning styles of students enrolled in a taxation course and its impact on students' performance. The results showed that most students preferred a Converging or Assimilating learning style. In theory, students who prefer the Converging learning style have dominant learning abilities of abstract conceptualisation and active experimentation. They tend to focus on practical application of concepts and ideas, and like to converge quickly to make a decision or obtain one correct answer. These characteristics are typical of the accounting students enrolled in the taxation course, where many are after the "correct answer" and are consistent with Kolb's identification of accountants as Convergers. This style is more evident in off-campus students, who are mostly working part-time or full-time. Being in a working environment perhaps explains their preference for "active experimentation," where they learn through doing.

This study found that accounting students can also be Assimilators which is not consistent with Kolb's model. In theory, Assimilators excel in integrating knowledge from various information sources. They prefer logic and order, and factual and accurate information, and their expert opinion also fits in well with the accounting discipline. This style is more evident in on-campus students who prefer to attend class and learn by watching what the teachers show them in class. This result is consistent with findings from studies conducted in recent years.<sup>78</sup>

Interestingly, there were no significant differences in performance between Converging and Assimilating students in the taxation course. There were no significant differences in students' performances in tests 1 and 2 but off-campus students outperformed on-campus students in the final exam. Kolb<sup>79</sup> suggests that the multiple choice question format of assessment tends to favour Convergers. But this is not the case in this study,

<sup>78</sup> See, eg, Holley and Jenkins, above n 8; Loo, above n 8; Marriott, above n 8; Novin, Arjomand and Jourdan, above n 47; and Adler et al, above n 9.

<sup>79</sup> Alice Kolb and David Kolb, *The Kolb learning style inventory – Version 3.1 2005 technical specifications Experience Based Learning Systems* (HayGroup, 2005) at 31.

as the multiple choice questions, unlike the typical format, required further justifications. Of note is that these two learning styles do have a common preference for abstract conceptualisation – students with these styles like to learn through thinking. The taxation course requires students to understand and apply concepts in answering assessment questions and therefore a preference for a logical, reasoning learning style is well suited for the type of assessment set in this course (ie, multiple choices with justification and short answer application type questions). The findings of this study indicate that the association between learning style differences and performance may not be generalised where the testing or assessment formats vary. Differences in findings may be attributed to differences in the assessment approach. This suggests that within disciplines and professions, even when the material and subject matter are similar, learning styles may vary in their impact on performance if types of assessments are different.

Further, in addition to their preferred styles, this group of accounting students had already been exposed to a variety of learning situations in their first year core papers. Although lecturers may not be conscious or aware of their individual students' learning styles, they often adopt a variety of teaching and learning approaches to enhance the learning and performance of students. Exposure to different learning approaches may have helped students in developing their ability to adopt different learning styles in different learning situations, recognise their own learning strengths and preferences, and approach learning situations with flexibility.<sup>80</sup>

The limitation of this study needs to be noted. The response rate is low and the findings may not be subject to generalisation. Students might have found Kolb's LSI instrument, which used a forced choice format, difficult to answer and therefore may not have been willing to make the effort to participate voluntarily on-line. Many studies with a high response rate have been conducted in class.<sup>81</sup> Interestingly, even though Marriot administered the questionnaire under controlled conditions in the class and achieved a response rate of 94%, about 93 (36%) of the responses were invalid due to an incorrect way of ranking. Sugahara and Boland<sup>82</sup> collected additional samples five months later to increase the number of respondents as the initial response rate was low. Even then some responses were incomplete. This further confirmed that students do not find the questionnaire easy to complete and better instructions are required to achieve higher valid responses, even when data is collected in class.

The data in this study was collected from only one university in New Zealand and therefore may not be representative of students in other universities either in New Zealand or overseas. The fact that there were so few students that are classified as Divergers or Accommodators must be acknowledged and this may be attributed to the small sample size. Our study also did not capture many international students to allow us to investigate the possible association between culture and learning style. Future research may examine learning styles in diverse cultural settings or use classroom assessment techniques to get feedback on what students have learned under various

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<sup>80</sup> See Entwistle, above n 4; and Loo, above n 8.

<sup>81</sup> See, eg, Cano-Garcia and Hughes, above n 10; and Marriot, above n 8.

<sup>82</sup> See above, n 8.



teaching approaches.<sup>83</sup> The findings may help teachers to identify common mistakes and points of confusion in the learning process and also consider various teaching strategies to engage students in multicultural settings.<sup>84</sup> This cross-sectional study does not examine changes in students' learning styles. A longitudinal study on learning styles would indicate whether there are changes in learning styles over the years.

Despite the limitations, the findings of this study lend further support to establishing students' diversity in their learning preferences. However, rather than trying to tailor different teaching methods to suit students' learning styles, tax educators can certainly help students in becoming "balanced" learners. An effective teacher can create an environment for maximum self-development where students are involved in heterogeneous group learning situations. Different teaching strategies can be used to help students develop their communication, problem-solving and critical thinking skills, attitudes and abilities. They can then adopt the learning style most appropriate to a given situation's demands, leading to more effective learning.<sup>85</sup> For instance, studies have shown that the use of case studies does modify students' approaches to learning.<sup>86</sup> Incorporating a diversity of teaching and learning approaches, such as lecturing, assigning relevant reading materials or watching video clips, computing income tax liability, solving tax problems, devising a tax plan, using tax case studies and using discussion groups, will provide students with the opportunity to reflect and apply what they have learned to various tax situations. It will also encourage them to take a deeper and more thoughtful approach to their learning,<sup>87</sup> and help de-emphasise the single solution approach.<sup>88</sup>

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<sup>83</sup>Philip Cottell and Elaine Harwood, 'Using Classroom Assessment Techniques to Improve Students' Learning in Accounting Classes' (1998) 13 *Issues in Accounting Education* 551.

<sup>84</sup>Peggy Hite and John Hasseldine, 'A Primer on Tax Education in the United States' (2001) 10 *Accounting Education* 3.

<sup>85</sup> See Wilson and Hill, above n 36; and Adler et al, above n 9.

<sup>86</sup> See P Libby, 'Barriers to Using Cases in Accounting Education' (1991) 6 *Issues in Accounting Education* 193-213. Gordon Boyce, Sarah Williams, Andrea Kelly and Helen Yee, 'Fostering Deep and Elaborative Learning and Generic (Soft) Skill Development: The Strategic Use of Case Studies in Accounting Education' (2001) 10 *Accounting Education* 37; and Sidney Weil, Peter Oyelere, Joanna Yeoh and Colin Firer, 'A Study of Students' Perceptions of the Usefulness of Case Studies for the Development of Finance and Accounting-Related Skills and Knowledge' (2001) 10 *Accounting Education* 123-146.

<sup>87</sup> Carl Christensen, *Teaching and the Case Method* (Harvard Business School, 1987) 3; and Louise Mauffette-Leenders, *Learning with Cases* (Ivey, 1997) 3.

<sup>88</sup> Shahrokh Saudagaran, 'The First Course in Accounting: An Innovative Approach' (1996) 1 *Issues in Accounting Education* 83; and Adler et al, above n 9.

**A COMPARATIVE ANALYSIS OF INCOME TAXATION ISSUES OF INTELLECTUAL PROPERTY FROM THE PERSPECTIVE OF DEVELOPED AND DEVELOPING COUNTRIES**

MAHMOUD ABDELLATIF\*

**ABSTRACT**

Intellectual Property (IP) plays an important role in accelerating economic growth rates and consequently economic development, because of its effects on technology transfer and creation of other positive externalities. The role of IP in economic development is based on a number of factors involving taxation, specifically income taxation. The increasing volume of IP business transactions raises the issue of the capacity of income tax regimes in developed and developing countries to achieve two conflicting objectives: (i) protection of the tax base of IP transactions and (ii) encouragement of self development of IP. This paper makes a comparative analysis of the domestic income tax treatment of IP business transactions from the perspectives of developed (Australia) and developing countries (Egypt and India). The analysis of the income tax treatment of IP transactions in these countries reveals that similar approaches are often employed by countries with regard to the protection of tax revenue from IP business transactions. However, all countries need to provide specific tax treatment with respect to the disposition proceeds of the IP transactions. On the other hand, different approaches are employed to encourage self development of IP which reflects the overall difference in tax policy. In this respect, Australia has an approach to encourage self development of IP which is similar to the majority of developed countries. However, it needs further improvement in terms of providing specific tax privileges to direct investments in R&D activities and exploitation of IP. The Indian income tax legislation is similar to the Australian for encouraging self developed IP. It is considered to be better than the Egyptian tax legislation and better than that in many developing countries. Accordingly tax legislation, particularly in developing countries, can play a significant role in stimulating self developed IP which leads to higher levels of economic growth and development.

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## I INTRODUCTION

Intellectual Property (hereafter, IP) is an important component of many business transactions, in particular for specific industries such as information technology, biotechnology, communications, and pharmaceuticals. Moreover, the importance of IP in business transactions has increased significantly in recent years, as a result of the implementation of the TRIPS agreement.<sup>1</sup> This was a significant outcome of the GATT agreement, which led to the establishment of the World Trade Organisation (WTO).

Developing countries represent the majority of the WTO member countries and they are required to fulfil the membership obligations related to IP protection. Consequently, the bulk of developing countries carried out many reforms of IP legislation and institutions. This had a significant impact on IP protection and consequently encouraged domestic and international companies to be extensively involved in IP business transactions and development.<sup>2</sup>

This development in IP protection addresses a number of tax issues. Those issues relate to the capability of the tax legislation to achieve two objectives: (1) protecting the tax base and (2) encouraging the development of in-house IP. Therefore the question arises: 'How should developed and developing countries tax IP transactions properly?'

The answer to this question requires the following approach:

- (i) Reviewing the literature and practices of the tax treatment of IP;
- (ii) Identifying the tax treatment of IP transactions under the Australian, Egyptian and Indian Income Tax Legislation, as examples of developed and developing countries; and
- (iii) Assessing the tax treatment of IP in these tax jurisdictions in accordance with adequacy and efficiency criteria.<sup>3</sup>

The adequacy criterion is an indicator of the capability of tax legislation in protecting the tax base which exhibits a country revenue need.<sup>4</sup> In this context, taxation of intellectual property rights (hereafter, IPR) raises the capability of tax legislation in tracing IP business transactions. In doing so, an analysis of the tax provisions relating

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<sup>1</sup> Trade related aspects of intellectual property rights, known as the TRIPS agreement, is an integrated part of the GATT agreement, which led to the establishment of the World Trade Organisation (WTO) in 1995. This agreement set benchmark measures for protecting IP worldwide. Those measures have to be addressed within the domestic legislation of respective member countries of WTO. For more details see, WTO, '**Agreement on Trade-Related Aspects of Intellectual Property Rights**', available online at <[http://www.wto.org/english/tratop\\_e/trips\\_e/t\\_agm0\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm)> (at 2 July 2009).

<sup>2</sup> For more detail see for example, Bernard M. Hoekman et al, 'Transfer of Technology to Developing Countries: Unilateral and Multilateral Policy Options' (2005) 33 (10) *World Development* 1578.

<sup>3</sup> See Josef T Sneed, 'The Criteria of Federal Income Tax Policy' (1965) 17(4) *Stanford Law Review* 567, 568.

<sup>4</sup> Ibid.

to various types of IP business transactions is carried out in accordance with income tax legislation in some developed and developing countries.

On the other hand, economic efficiency criterion is concerned with correcting market failure associated with specific business activities.<sup>5</sup> The specific nature of IP, particularly that part that relates to the self development activities of IP, requires specific tax treatment. Therefore, the tax treatment of the transactions and activities related to stimulating self developed IP will be analysed. The analysis focuses on Australia as an example of developed countries, and Egypt and India as examples of developing countries.<sup>6</sup> The choice of these countries is also supported by the study of Sanjaya Lall who developed an indicator for technological activity.<sup>7</sup> In accordance with this indicator, countries around the world were classified into four groups of technological activities which are:

- i. Intensive technological activity group which includes developed countries which will benefit from strong IPR protection measures.
- ii. Moderate technological activity group which includes some developed and developing countries which will benefit from strong IPR protection measures and bear some costs.
- iii. Low technological activity group which includes major developing countries. Those countries are expected to bear significant costs from strong IPR protection measures while in the long run they will get potential benefits.
- iv. Negligible technological activity group. This last group includes less developed countries which bear significant costs from strong IPR protection measures forever without potential benefits.<sup>8</sup>

Australia was ranked in the first group whereas Egypt and India were ranked in the third group in respect of which there are current costs and potential benefits.<sup>9</sup> This addresses the role of the tax system to deal with maximising benefits with regard to Australia while minimizing current costs and increasing potential benefits in a case of Egypt and India.

Accordingly, this paper proceeds as follows. The second section reviews literature related to taxation of IP transactions. Sections Three to Five analyse and assess the tax treatment of IP licensing, IP transfer, and self-developed IP under Australian, Egyptian and Indian income tax legislation. Section Six analyses and assesses the impact of specific tax treatment for specific entities on taxation of IP, in these tax jurisdictions. Section Seven assesses the overall impact of tax policy on the tax treatment of IP under Australian, Egyptian and Indian income tax legislation. Section Eight is a summary conclusion.

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<sup>5</sup> Jane G.Gravelle, *The Economic Effects of Taxing Capital Income* (MIT Press, 1<sup>st</sup> ed, 1994), 29.

<sup>6</sup> The reasons for choosing these countries are related to economic and technical factors. For the economic factors Australia is a developed country which was ranked number 2 according to the human development index, while Egypt and India were ranked as 123 and 134 respectively as medium human development. In addition both Egypt and India are considered leading countries in their regions. On the other hand, the technical issue is related to the author's interests in examining the tax systems in these countries.

<sup>7</sup> Sanjaya Lall, 'Indicators of the Relative Importance of IPRs in Developing Countries' (2003) 32(9) *Research Policy* 16571664.-1665.

<sup>8</sup> Ibid 1664.

<sup>9</sup> Ibid 1666.

## II LITERATURE REVIEW

### *A An Overview of IP Business Transactions*

Assessing the tax treatment of IP in terms of the desired objectives requires at the outset a determination of the various types of IP business transactions, and the involved parties. Those transactions take a number of forms, which reflect business preferences. However, the most common forms are licensing and transfer in addition to self-developed activities of IP.<sup>10</sup> Those forms are the most common forms for technology transfer and development, because the holder of IPR is more concerned to license or transfer it to a new user for a number of reasons such as market strategy and profit maximisation.<sup>11</sup> Those forms address a number of legal and tax issues. Following is a brief description about each form, which will enable us to understand the tax consequences arising from carrying out each one.

Licensing of IP subject matter is similar to licensing any other business asset. This process has two parties, a licensor and a licensee. The licensor of the IP subject matter is the owner/holder. It has the right to license for use the IP subject matter to someone else in return for specific consideration. On the other hand, a licensee of IP has the right to use the IP subject matter in its business operations in return for a royalty paid to a licensor.<sup>12</sup> Figure 2.1 illustrates the licensing of IP subject matter.

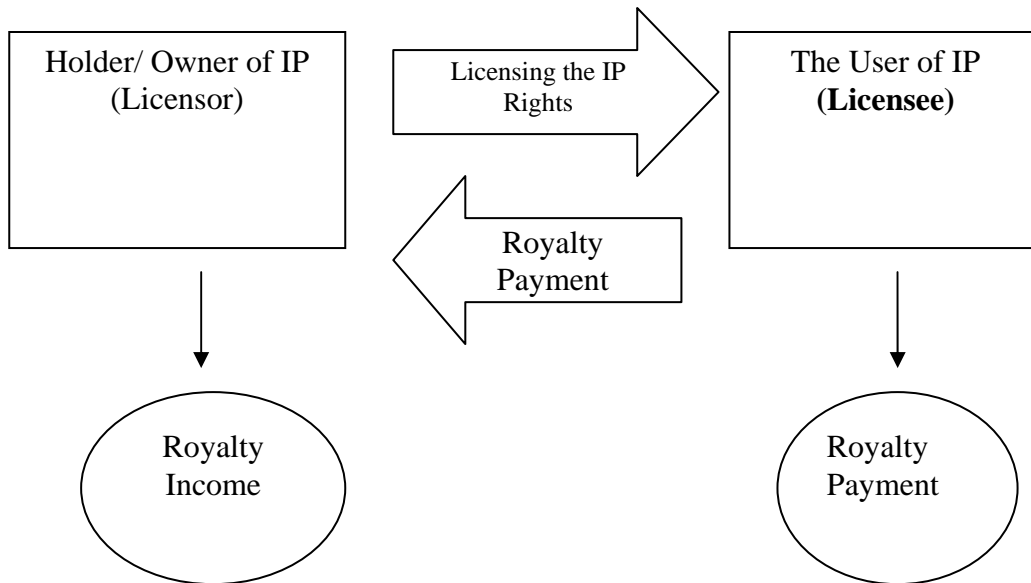
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<sup>10</sup> In addition to the abovementioned IP transactions, Rider et al added two more types which are (i) the use of IP in carrying out R&D activities in behalf of a third party, and (ii) the use of IP in collaborative research projects with other scientific institutions. For more details, see Cameron Rider et al, 'Taxation Problems in the Commercialisation of Intellectual Property' ( Intellectual Property Institute of Australia, the University of Melbourne, IPRIA Report 1/06, 2006), 15. It is available online at < [http://www.ausicom.com/dbase\\_upl/tax\\_IP.pdf](http://www.ausicom.com/dbase_upl/tax_IP.pdf)> accessed at 2 May 2008.

<sup>11</sup> See Shamila Vishwasrao, 'Intellectual property rights and the mode of technology transfer' (1994) 44(2) *Journal of Development Economics* 381.

<sup>12</sup> There is a difference between a royalty payment and a licensing fee. A royalty payment is an amount paid under specific conditions such as number of units produced, sales volume, etc, which implies that a royalty is a variable amount. On the other hand, a licensing fee is a fixed amount paid by a licensor to a licensee regardless of any other variables. For more details see Debapriya Sen 'Fee Versus Royalty Reconsidered' (2005) 53 (1) *Games and Economic Behavior* 141, 141-142.

**Figure 2.1 illustrates the elements of licensing transactions.**



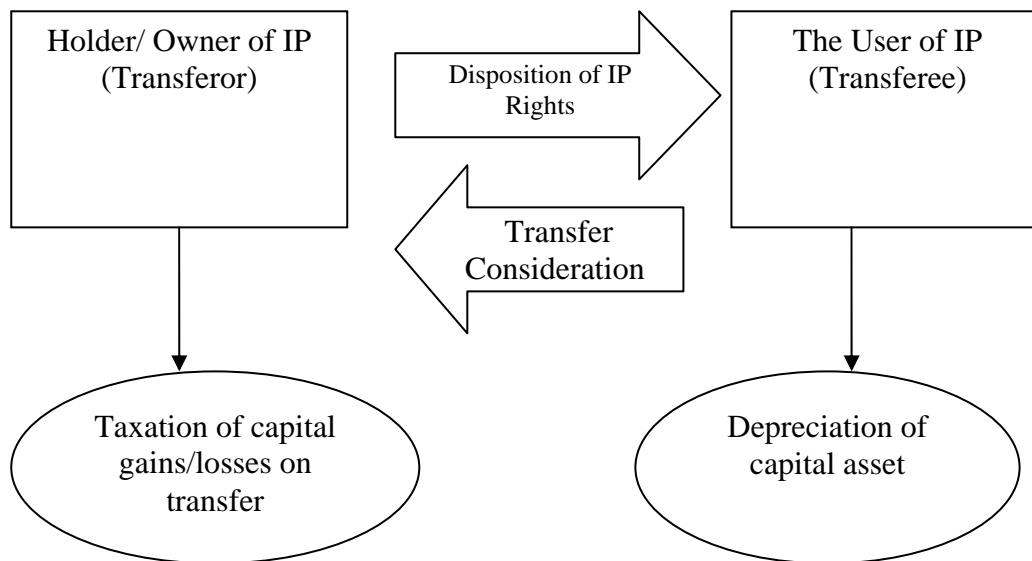
The above figure has two parts. The upper part shows the contracting transaction, while the lower part shows the financial outcome, which creates two tax issues:

- (i) Taxing the royalty income in the hands of the licensor; and
- (ii) The deductibility of the royalty paid by the licensee.<sup>13</sup>

Another type of IP business transaction is IP transfer. It is different from the licensing in terms of the exclusivity of rights. An IP transfer gives the transferee an exclusive right to use, exchange, or sub-license the IP to one or more third parties. Therefore, a transfer is similar to the sale of a capital asset. The owner/holder of the IP receives specific consideration in return for completing a transfer of the IP subject matter. The tax treatment of the consideration for the transfer of the IP is similar to the tax treatment of the consideration for the sale of other capital assets. The concern will usually be the capital gains or losses that arise from the transfer. Figure 2.2 illustrates the transfer process.

<sup>13</sup> *Income Tax Law No 91 of 2005*



**Figure 2.2 illustrates the IP Transfer Transaction and Related Tax Issues**

The third type of IP business transaction is self-developed IP. Self development of IP is common practice in many industries, especially pharmaceutical and information technology, as a result of extensive spending on R&D activities.<sup>14</sup> This type of expenditure is an important means for creating in-house IP such as know-how, patents, and secret formulas. The R&D expenses consist of recurrent expenses and capital expenses. Recurrent expenses mainly consist of salaries and materials used in experiments. Capital expenses consist of depreciation of capital assets, such as scientific apparatus, laboratories, buildings and fixtures

### **B Taxation of Licensing IP**

The licensing contract defines and enables the exclusivity of rights, the term of the contract, the royalty payment, the territory of the contract, transferability, and sublicensing.<sup>15</sup> The tax treatment of licensing is often determined based on the exclusivity.<sup>16</sup> Therefore, identifying the distinction between different types of IP licensing transactions in terms of exclusivity is important. In this context, there are three types of licensing:<sup>17</sup>

- i. Exclusive license. Here the licensor gives exclusive rights to the licensee of the IP. Accordingly, the licensor cannot use the IP asset any longer, because the monopoly power has been transferred to the licensee. This transfer of the IP is

<sup>14</sup> For more detail see for example, Richard R. Nelson and Paul Romer, 'Science, Economic Growth and Public Policy' in Bruce L.R. Smith and Claude E. Barfield (eds), *Technology, R&D and the Economy* (Brookings Institutions and the American Enterprise Institute for Public Policy Research, 1995) 49, 49-74.

<sup>15</sup> Paul McGinness, *Intellectual Property Commercialization: a business manager's companion* (2003) 230.

<sup>16</sup> The degree of exclusivity provided by a licensing contract determines whether the licensing proceeds are treated as ordinary income or capital gains. In this respect, see the Australian High Court case, *FCT v McNeil* [2007] HCA 5, (2007) 233 ALR 1; (2007) 81 ALJR 638 (22 February 2007).

<sup>17</sup> Paul McGinness, above n 15, 231.

- the same as the disposition of IP, or sale of tangible property, where the seller cannot use it after the sale.
- ii. Non-exclusive licensing. This implies that the licensor licenses the IP subject matter to a number of licensees. In addition, the licensor can continue to use the IP.
  - iii. Sole licensing. This implies that the licensor licenses the IP to one licensee only.

The involved parties in these transactions are subject to different tax treatment which depends on (i) the position of each party, whether he is a holder or user of IP, and (ii) the nature of the transferred rights. The following section discusses the tax treatment of each type of transaction in detail.

### *1 Taxation of Licensing Proceeds*

To protect the tax base in so far as it consists of income from IP business transactions, it is necessary to identify and define that income generated from them. Accordingly, determining the tax treatment of licensing transactions requires an accurate definition of the licensing proceeds/ consideration, which is usually called a royalty.<sup>18</sup> A royalty can be defined as the amount paid by the licensee to the licensor in return for using the IP subject matter. There may be slight or considerable differences among definitions used by countries. However it is useful to refer to the standard definition of 'royalty' as defined by the OECD, which defines 'royalty' as:

Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.<sup>19</sup>

This definition sheds light on the specific elements of a royalty.

- i. A royalty is related to the use of rights. Those rights are driven by holding any type of IP;
- ii. the registration of IP with a register is not a prerequisite for licensing the IP and obtaining a royalty;
- iii. Royalty income is not limited to licensing contract payments only. It extends to cover the compensation paid for the infringement of rights, or other fraudulent uses; and
- iv. Income arising from rendering a service or the leasing of real property is not a royalty.

The tax treatment of royalty receipts within one tax jurisdiction, in the hands of a licensor, seems to be straightforward. It should be included in assessable income along with revenues derived from other sources. However, the form and timing of the royalty payments may complicate the tax treatment.

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<sup>18</sup> The royalty concept is widely used in the area of licensing/exploitation of mineral resources, and sometimes in leasing contracts (rather than rent). For an explanation of the royalty concept see Lee Burns and Richard Krever, 'Taxation of Income from Business and Investment', in Victor Thuronyi (ed), *Tax Law Drafting and Design* (IMF 1998) 597, 615- 617.

<sup>19</sup> See Article 12(2), *OECD: Model Tax Convention on Income and Capital* (July 2008), 30.

Royalty payments take two forms; a lump sum payment or revenue stream. Both are often taxable under ordinary income tax rules.<sup>20</sup> In the UK, the lump sum payment is taxed in six taxable periods, which means 1/6<sup>th</sup> of the payment is taxed every taxable period.<sup>21</sup> However, the former is certain and the latter is contingent. The contingency is related to the various bases that are used to calculate the amount of the royalty payment. Those take a number of forms, such as the number of units produced in the case of licensing process/know-how, the number of units sold in the case of licensing patents, and sales volume in the case of licensing trademarks.<sup>22</sup>

Timing is an important element with respect to recognition of licensing income. Accounting principles tend to be more conservative in this respect, in particular with regard to contingent income. However, the conservatism principle is not acceptable in determining assessable income arising from licensing transactions.<sup>23</sup> Identifying the time of the income flow is an essential basis for income recognition in accounting and taxation.<sup>24</sup> The accrual basis is the basis for recognising income of corporations in accordance with generally accepted accounting principles (GAAP).<sup>25</sup> Accordingly, the royalty income is often recognised as taxable income when it is accrued in the hands of the recipient regardless of payment time.

Royalty payments from a resident licensee to a resident licensor are either exempted from withholding tax, which is imposed on non-resident licensors, or subject to an assessment on a withholding tax basis.<sup>26</sup> For example, the UK *Income Tax Act 2007* (hereafter UK ITA 2007) levies a withholding tax under two circumstances. The first case is when a royalty is paid on a regular basis. Withholding tax is levied in accordance with s 901. On the other hand, when a royalty is paid on an irregular basis (e.g. lump sum), withholding tax is levied in accordance with s 903. Moreover, section 903 levies a withholding tax at the basic rate on royalty payments related to patents or other intangible assets.<sup>27</sup> The withholding tax on domestic transactions of IP is often intended to track those transactions in order to protect tax revenue.

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<sup>20</sup> Jeffrey A. Maine and Xuan-Thao Nguyen, *Intellectual Property Taxation: Transaction and Litigation Issues* (BNA Books 1<sup>st</sup> ed, 2003) 341-342.

<sup>21</sup> For more details on taxation of lump sums in the UK, see H.M. Revenues & Customs, 'CA75210, Patents Sale of patent rights: Taxation of lump sum', available online at <<http://www.hmrc.gov.uk/manuals/camanual/CA75210.htm>>, accessed at 13 September 2008.

<sup>22</sup> For more details with regard to the basis of calculating royalty see, Paul McGinness, above n 15 358-360.

<sup>23</sup> For more details with regard to the income recognition issue, see Lee Burns and Richard Krever, above n 18, 632- 634.

<sup>24</sup> Taxation income realisation/recognition rules sometimes deviate from accounting rules, because of different measurement objectives for each one. Taxation is concerned with measuring income that is based on a periodical basis and the 'ability to pay' principle, while accounting is concerned with measuring, income that is based on going concern and conservatism principles.

<sup>25</sup> David A. Guenthera, Edward L. Maydew, and Sarah E. Nutter, 'Financial Reporting, Tax Costs, and Book-tax Conformity' (1997) 23(3) *Journal of Accounting and Economics* 225, 226.

<sup>26</sup> In Portugal royalty payments among resident taxpayers are subject to withholding tax. A payer has to withhold 15% from the payee as a tax payment in advance, and the payee has to claim this percentage from his final tax liability. For more details see Rui Camacho Palma, 'Portugal: Income Taxation of Intellectual Property and Know- How: Conundrums in the interpretation of domestic and treaty law' (2004) 44(11) *Journal of European Taxation* 482.

<sup>27</sup> Anne Fairpo, *Taxation of Intellectual Property* (Bloomsbury Professional, 2<sup>nd</sup> ed, 2009) 132-133.

## 2 Taxation of Licensing Payments

The deductibility of the IP licensing fees is another issue in the licensing transaction from the viewpoint of a payer/licensee. Licensing fees are often treated as a recurrent expenditure rather than capital expenditure. This treatment is in line with the matching principle, which is a cornerstone of accounting for revenues and expenses.<sup>28</sup> Further, the tax rules are often intended to be in line with that principle through setting a nexus between the claimed expense and the assessable income. On the other hand, deductible expenses raise the timing issue, that is, when is the expense tax deductible?<sup>29</sup> Burns and Krever addressed two arguments to answer this question. Those are (i) the legal-economic liability and (ii) the cash economic liability.<sup>30</sup>

The legal-economic argument is explained through implementation of the accruals basis. The expense is due when it has been incurred which represents the legal aspect. The economic aspect of the accruals basis implies that goods or services were provided/rendered. Applying this analysis to the licensing of IP subject matter implies that a licensee should claim a deduction for a royalty payment when the two aspects (legal and economic) of the accruals basis have been fulfilled. Conclusion of a licensing contract satisfies the legal aspect. However this is insufficient for deducting a royalty payment from assessable income. It must be accompanied by the economic aspect. Using the rights of the IP in the production or sales process satisfies the economic aspect. The royalty, therefore, accrues regardless of payment and it should be considered as a current tax-deductible expense.

The second argument is the cash-economic liability argument. You can deduct an expense when it has been paid for. However, this alone is insufficient without receiving the goods or rendered service. Therefore the licensee cannot claim the payment related to the IP licensing contract, unless the relevant IP (e.g. patents, know-how or trademark) rights have been received.

The common approach is to use the legal-economic rule rather than the cash-economic rule. The former is consistent with accounting standards. In this regard, tax legislation tends to minimise the deviation between accounting and tax rules.

The above discussion of both rules is relevant for all business transactions as well as IP transactions.<sup>31</sup> Nevertheless, additional criteria that reflect the specific nature of IP, in particular a limited useful life of many IP assets, are needed. This condition ensures that

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<sup>28</sup> Ibid 21-22.

<sup>29</sup> For example, subsections 8-1(1) and (2) of the Australian *Income Tax Assessment Act 1997* (hereafter ITAA 1997) set specific criteria for deductibility of business expenses (more details will be explained in the Australian section of this paper).

Also, section 162, of Internal Revenue Code of the US identifies the general rule for the deductibility of current expenses. Maine & Nguyen noted that:

It is allowed to the taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. This deduction is available under the following conditions; (i) it is a current expense rather than capital expense, (ii) it is incurred in the ordinary course of business and (iii) it is necessary for deriving taxable income.

Jeffrey A. Maine and Xuan-Thao Nguyen, above n 2020, 103.

<sup>31</sup> In this part, the discussion is more general rather than focusing on a specific tax jurisdiction. This general discussion gives a broad scope for tax policy makers to design the relevant tax provisions which serve their objective of taxing IP.

the licensing contract is within the term of the IP subject matter, for example, a licensing contract that is limited to the protection of a patent or trademark. If the licensing contract exceeds the patent term, the related royalty payment should be denied. The expiration of a patent term gives the right to the licensee to use the patent without the permission of the patent holder. Accordingly, the licensee could not claim a royalty payment for an expired patent. This condition is necessary especially when the licensee and licensor are related persons.

### *3 Taxation of Compulsory Licensing<sup>32</sup>*

Compulsory licensing of IP is a new mechanism which was introduced by the TRIPS agreement. This mechanism aims to solve specific issues related to using a patent without the permission of its owner/holder. Article 31b of the TRIPS agreement identifies when compulsory licensing is allowed, and what is the commitment of the licensee.<sup>33</sup>

A licensee is obliged to pay a reasonable remuneration to a licensor. The licensing rights are non-exclusive and the consideration for compulsory licensing and other related issues are subject to judicial review. The tax treatment of remuneration, therefore, is similar to the licensing revenue stream. In this respect, the remuneration for compulsory licensing represents a revenue stream to the licensor. This revenue should be included in the assessable income of the licensor. On the other hand, when a licensee is a taxable person, it is qualified to deduct licensing fees (royalty payments) from its taxable income in a similar way to normal licensing, as previously discussed.<sup>34</sup>

### *4 Taxation of Infringement Awards and Compensation*

Disputes often arise relating to patent infringements or the passing off of a trademark. The patent holder/trademark owner bears the bulk of negative impacts of the infringement. They have to protect their rights by legal proceedings against the infringer or via an out-of-court settlement. If the holder wins the case or reaches a settlement with the infringer, the infringer may have to pay a specific amount (award) to the holder.

There is a strong debate about taxation of infringement proceeds. For example, Cutler set a number of criteria for considering litigation proceeds as income. For example, the proceeds must be in lieu of income foregone, that is, an award not related to personal damage, etc.<sup>35</sup> But the infringement award also poses a capital gains tax issue.<sup>36</sup> In accordance with Cutler view, when the compensation is related to an income loss, it is treated as income and subject to ordinary income tax rules. Compensation payments for

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<sup>32</sup> Compulsory licensing is often used in the pharmaceutical industry. It was mainly introduced to deal with public health difficulties that many developing countries face. However, many developed countries use it. There are many examples of compulsory licensing in developed countries. For more details, see Mohamed Salem Abou El-Farag, 'TRIPs, TRIPs-plus, Developing Countries and Public Health: the Case of Egypt' (2008) 5(1) *Journal of International Biotechnology Law* 1, 9.

<sup>33</sup> For more details, see Article 31 of the TRIPS agreement.

<sup>34</sup> Anne Fairpo, above n 27, 32.

<sup>35</sup> For more detail see Charles R. Cutler, 'Taxation of the Proceeds of Litigation' (1957) 57(4) *Columbia Law Review* 470.

<sup>36</sup> For more detail in this respect see Bryan R. Krouse, 'Patent Infringement: Lessons from Industrial Economies' (2004) 4 (3) *Journal of Industry Competition and Trade* 191.

capital gains/losses are subject to the capital gains tax regime. In order to determine the taxable capital gain or loss arising from a compensation payment, a cost base must be identified,<sup>37</sup> as will be discussed in the following section.

In the US, infringement awards relating to a patent are considered ordinary income since income of the patent holder has been negatively affected by the infringement, which had affected the holder's tax base in previous periods.<sup>38</sup> So the award for patent compensation is added to taxable/assessable income and treated as a revenue stream. On the other hand, compensation for a trademark infringement is considered a capital receipt because the goodwill of the trademark holder has been negatively affected. Therefore, the cost base of the trademark (goodwill) is deducted from the compensation payment to determine the amount of the capital gain or loss.<sup>39</sup>

### ***C Taxation of IP Transfer***

The transfer of an IP asset from the owner/holder to someone else may occur in either of two ways. The first is a commercial transfer in which a transferee is obliged to pay a specific consideration to the transferor in return for transferring the rights pertaining to the IP. The second is a donation, in which the transferee obtains the IP owner's rights to use IP without any compensation under specific conditions. The tax treatment for each type of transfer is different. The focus here is only on the first type of transfer, which significantly affects the taxable income of the transferor.

#### *1 Taxation of a Transfer Proceeds/Consideration*

The transfer/sale of IP poses the issue of how to tax the sale proceeds or consideration. The consideration for the IP subject matter sale/transfer takes two forms. It can be a lump sum or via instalment payments. Thus, the consideration is not a revenue stream, because it does not meet the ordinary income criteria: (i) inflow, (ii) periodicity, and (iii) separation from the source.<sup>40</sup> In this context, in the UK, when a patent is disposed of in exchange for instalment payments, it is treated as capital income and the capital gains attributed to each instalment paid on a 1/6<sup>th</sup> basis.<sup>41</sup>

A transfer of IP is similar to the disposition of other tangible and intangible assets.<sup>42</sup> The outcome of a transfer of IP or a disposition of capital assets usually results in a capital gains tax event. A capital gain or loss is usually the difference between the consideration proceeds and the cost base of the disposed asset. This implies that a consideration amount will be above or below the cost base. May defined capital gains as 'the profit upon realization of assets otherwise than in the ordinary course of business, this profit being the excess of the proceeds of realization over the cost of property realized'.<sup>43</sup> This definition gives three conditions for identifying capital gains tax events:

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<sup>37</sup> Charles R. Cutler, above n 35, 475.

<sup>38</sup> See Jeffery A. Maine and Xuan-Thao N. Nguyen, above n 20, 509-516.

<sup>39</sup> Ibid 515.

<sup>40</sup> Kevin Holmes has developed the income pyramid. It consists of legal, economic and accounting concepts of income, with criteria attached to each concept. See Kevin Holmes, *The Concept of Income a Multi-disciplinary Analysis*, (IBFD, 1<sup>st</sup> ed, 2000), 164-166.

<sup>41</sup> See Anne Fairpo, above n 27, 86-87.

<sup>42</sup> See Anne Fairpo, above n 27, 101-103.

<sup>43</sup> George O. May, 'Taxation of Capital Gains', (1922) 5(34), *Journal of Accountancy*, 321, 331.



- i. Capital gains are recognised on a realisation basis rather than an accrual basis;
- ii. The pertinent business transaction does not occur in the ordinary course of business; and
- iii. The consideration received exceeds the cost base.

The first condition is important for recognising that the transfer of an asset from the seller to the buyer has taken place. This is a necessary condition for a capital gain. If the market value of an asset has increased, but the asset owner still possesses it, there is no capital gain.<sup>44</sup> The realisation criterion is applicable for tangible as well as intangible assets (i.e. IP). In the case of an IP transfer, realisation of a capital gain or loss implies that the transferor has transferred the IP rights and related risks to the transferee.<sup>45</sup>

The second condition is related to the nature of capital gains and business transactions. Those business transactions occasionally occur. When the sale of a capital asset occurs in the ordinary course of business, the realised gain is treated as ordinary income. The specific nature of IP means the transfer of IP often occurs as an isolated event. Therefore, the realized gain is a capital gain.<sup>46</sup>

The third condition for a capital gain is that the consideration amount exceeds the cost base of the sold/ transferred asset. If this is not the case, the seller realises a loss. This condition addresses the issue of identifying the cost base of the sold or transferred asset. The cost base is the historical cost of acquisition of an asset.<sup>47</sup> This original cost typically consists of the purchase price, registration fees, instalment expenses, and any other capitalised expenses. Moreover, with IP, the distinction between in-house developed and purchased IP is an important matter. In the case of in-house developed IP, development expenditures are often expensed on a recurrent basis.<sup>48</sup> However, other registration fees and other expenses are capitalised. Those capitalised expenses represent the cost base of the transferred IP. This approach to calculating the cost base is applicable to tangible and other intangible assets as well as IP. An important issue in this respect is that the cost base must be adjusted to reflect any deducted depreciation or amortisation in accordance with tax legislation provisions.<sup>49</sup>

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<sup>44</sup> Kenneth L. Smith, 'Capital Gains and Losses in Accounting' (1939) 14(2) *The Accounting Review* 126, 126.

<sup>45</sup> Regardless of consensus among legislators that capital gains tax is based on the realisation principle, there is strong debate in academia about the advantages and disadvantages of the realisation principle against the advantages and disadvantages of the accrual principle. For more details, see Alan J. Auerbach 'On the Design and Reform of Capital Gains Tax' (1992) 82(2) *The American Economic Review* 263.

<sup>46</sup> In many cases, there may exist an independent firm which is involved in commercialisation of IP subject matter, such as the case of spin-off companies or other similar forms. In this regard the transfer of IP from that company to someone else is considered an ordinary business transaction, and the income which arises is considered ordinary income. For more details see, Cameron Rider et al, above n 10, 5-13.

<sup>47</sup> There is strong debate with regard to the basis of calculating the cost base, whether it should be based on historical costs, replacement costs, indexed costs or other measures. However, Burns and Kreyer have identified that the cost base should include the acquisition costs plus any ancillary costs arise from acquisitions, such as legal fees and stamp duty. For more detail see Lee Burns and Richard Kreyer, above n 18, 649.

<sup>48</sup> More details for in-house developed IP are in the following section.

<sup>49</sup> See Anne Fairpo, above n 27, 128-129.

## 2 Taxation of Acquisition of IP

IP subject matter is acquired by either purchase or self-development (creation). Purchase takes place through a transfer of IP, while self development takes place through carrying out R&D activities and spending on advertising, which leads to the development of IP. Development costs are often expensed as recurrent expenses.<sup>50</sup>

The transfer of IP subject matter is similar to the acquisition of a tangible asset. The transferee has exclusive rights to use the rights accompanying the transferred IP item. The transferee pays specific consideration to the transferor and incurs other incidental expenses related to the acquisition. The total amount is known as the acquisition cost. The benefits of acquisition flow within a specific number of years. This implies that there is a future benefit of acquisition. If so, acquisition costs should be amortised over a specific time.<sup>51</sup> That will depend on the time frame during which the future benefits are expected to occur. The amortisation expense is tax deductible according to the benchmark income taxation principles.<sup>52</sup> However, the tax treatment of amortisation differs from one tax jurisdiction to another. Deductibility of amortisation of IP acquisition costs is a function of a number of elements. These elements are the type of IP, the acquisition cost base, and the amortisation method.

With regard to the type of IP subject matter, some tax legislation allows amortisation for some types of IP (i.e. patents) and denies it for others. This will be discussed in the case of Australia (i.e. trademarks). A similar case exists to some extent in the UK. In this respect, the UK ITA 2007 provides a capital allowance for a number of forms of IP subject matters. These include a patent, a trademark and know-how.

Patents and trademarks are considered to be depreciable assets, if they are used in the business or for investment in accordance with s 466(2) of the *Capital Allowance Act 2001* (UK) (hereafter the UK CAA 2001). In order to work out the amortisation amount, acquisition costs which are known as available qualifying expenditure must be determined.<sup>53</sup> The difference between the qualifying expenditure and disposal receipts of the patent is added to the patent pool when it is positive. The patent pool qualifies for a 25 percent capital allowance. By contrast, under the UK CAA 2001, know-how does not qualify for a capital allowance when it is related to the goodwill.<sup>54</sup> Nevertheless the know-how can be treated similarly to a patent when the holder elects to not treat it as goodwill.<sup>55</sup>

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<sup>50</sup> More detail about self developed IP will be explained in the next section

<sup>51</sup> Jane G. Gravelle and Jack Taylor, '[Tax Neutrality and the Tax Treatment of Purchased Intangibles](#)' (1992) 45(1) *National Tax Journal* 77, 85-86.

<sup>52</sup> Drk-Jan Kraan, 'Off-Budget and Tax Expenditures' (2004) 4(1), *OECD Journal on Budgeting* 121, 130-131.

<sup>53</sup> There are two types of available qualifying expenditures: the first type is qualifying non-trade expenditure which belongs to the investment patent. On the other hand, the second type is qualifying trade expenditure which belongs to the trade patent. See Anne Fairpo, above n 27, 109.

<sup>54</sup> For more details see Andrew Lymer et al, 'Taxing the Intangible: Overview of global approaches and a review of recent policy changes in the UK' (2003) 18(4), *Australian Tax Forum* 431, 464.

Also see Richard Bramwell et al, *Taxation of Companies and Company Reconstructions* (Sweet & Maxwell, 1994) 188-189.

<sup>55</sup> Anne Fairpo, above n 27, 122-123.

With regard to the depreciation method, the UK implements an asset pooling system, through what is known as the patent pool or know-how pool, as explained previously. On the other hand, sections 167 and 197 of the US Internal Revenue Act allow using two methods of amortisation for specific items of IP.<sup>56</sup> Those methods are the straight line method and the income forecasting method. There are a number of prerequisite elements for each amortisation method, namely (i) cost base, (ii) asset expected useful life, and (iii) depreciation rates.

With regard to the depreciation rate, various approaches have been used to determine depreciation rates. When the tax legislation allows a higher rate (above the normal rates) to depreciate assets, it is known as accelerated depreciation. The objective of using accelerated depreciation is to encourage taxpayers to replace their old assets and acquire new technology. Also in many situations tax administrators issue rules to identify depreciation tax rates.

### *3 In-House Developed IP*

The tax treatment of self-developed IP is mainly concerned with the treatment of expenses incurred in the development process. Therefore, it is important to analyse the process of developing a new IP item in order to track various expenses items. The development process of any IP item has a number of phases which ultimately lead to its creation. For instance, the development of a new patented product or process in the pharmaceutical industry passes through a number of phases.<sup>57</sup> The first phase involves conducting pharmacological research. The second phase involves running pre-clinical research. The third phase is a clinical phase. The fourth phase is marketing. The ultimate outcome of this process is a patented product or process. This development process creates a number of tax issues for Research and Development (R&D) expenditures, marketing expenses and registration fees. On the other hand, developing other items of IP such as brand names, trademarks and undisclosed information (secret formula) involves incurring salaries, marketing expenses and registration fees. Accordingly the tax treatment of developing a new item of IP will require classification of the three types of expenditures, namely R&D expenditures, marketing expenditures and registration fees.

Many scholars and policy makers have paid more attention to the tax treatment of R&D as a result of its positive externalities. Accordingly, many countries have designed specific tax treatments for R&D to stimulate new inventions and innovations and hence create domestic IP subject matters.<sup>58</sup> This represents the other side of taxing IP subject

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<sup>56</sup> Jeffrey A. Maine and Xuan-Thao Nguyen, above n 20, 157- 174.

<sup>57</sup> The research in the pharmaceutical industry is complicated and costly. In order to proceed from one phase to another, the approval of the competent authority is required. For instance in the US, pharmaceutical firms are required to get the approval of the Food and Drug Authority (FDA), for carrying out the pre-clinical, clinical and marketing phases of any new drug. For more details, see Nina J. Crimm, 'A Tax Proposal To Promote Pharmaceutical Research, to Encourage Conventional Prescription Drug Innovation and Improvement and To Reduce Product Liability Claims' (1994) 29 *Wake Forest Law Review* 1007, 1017-1019.

<sup>58</sup> See for example, Jacek Warda, 'Tax Treatment of Business Investments in Intellectual Assets: an International Comparison' (DSTI/DOC) (2006/4), 13-28. It is available online at <

matters which is the macroeconomic aspect. The situation has encouraged scholars to investigate the tax treatment of R&D from different perspectives, such as how to design a type of specific treatment and assessing its efficiency.<sup>59</sup>

Marketing expenses are broader than advertising expenses. They include advertising expenses, salaries and wages of sales staff, and other promotional activities. This type of expense is often expensed recurrently as a part of ordinary expenses, as it is considered necessary for carrying on the business.<sup>60</sup> However, a strong debate exists with regard to advertising, especially when it relates to start-up expenses or an advertising campaign. In this regard the question arises whether there is a need to capitalise it or expend it as a revenue expense.<sup>61</sup> Tax legislation and court cases set specific criteria for capitalising any expenditure, such as that the term of future benefits must exceed the taxable period. Capitalisation of these expenses represents the development costs of trademark which often require considering it for amortisation purposes as previously discussed.

The tax treatment of registration fees of any asset is to treat them as capital expenditure, since they are considered a cost of protecting the capital asset.<sup>62</sup> For instance, in Australia the cost base of any capital asset has first element and second element costs.<sup>63</sup> First element costs include the acquisition cost, second element includes incidental costs, registration fees and other miscellaneous expenses which are necessary to prepare the asset for work. Therefore, registration fees and other legal fees related to protecting an IP item must be capitalised and amortised over a specific time.<sup>64</sup>

Based on the abovementioned discussion, the tax treatment of expenses that lead to the development of new IP subject matter are either expensed on the recurrent basis or capitalised and depreciated over a number of years. The former treatment is often granted to R&D expenses associated with creating patents, while the latter is more related to trademarks. Therefore, when self-developed IP items are transferred to someone else, the issue of cost base is posed as was discussed before. The tax treatment of advertising and other expenses except R&D is often straightforward and similar to other expenditure items whether related to intangible or tangible assets.<sup>65</sup>

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<http://puck.sourceoecd.org/vl=6418650/cl=15/nw=1/rpsv/cgi-bin/wppdf?file=5l9pscs408vl.pdf> >, at 29 December 2008.

<sup>59</sup> See Mahmoud Abdellatif, 'Looking for Efficient Tax Incentives to Stimulate Research and Development and Economic Growth' (2009) 15 (June) *New Zealand Journal of Taxation Law and Policy* 1.

<sup>60</sup> Capitalization of expenses is a problematic matter which sometimes forces taxpayers to seek a solution through the courts. This situation makes tax authorities concerned to solve the issue out of the courts through issuing relevant regulations which determine the required criteria for capitalizing expenditure. In this context, The Internal Revenue Service (IRS) has issued proposed capitalization regulations on 19 December 2002. For more details see Robert Feinschreiber and Margret Kent, 'Understanding the Capitalization Regulation' (2003) 4(5) *Corporate Business Taxation Monthly* 3.

<sup>61</sup> For more details with regard to the tax treatment of expenses of self-developed IP, see Jeffery A. Maine and Xuan-Thao N. Nguyen, above n 20, 99- 130.

<sup>62</sup> Harrison and Mucek have argued that costs incurred in protecting income is considered as current expenditure while costs incurred in protecting the asset itself, such as registration fees of trademarks, is considered as capital expenditures and must be capitalized. For more details see, Jack F. Harrison and Bradley J Mucek, 'Trademark Taxation: What's in a Name?' (1988) 41(Fall) *The Tax Executive*, 41.

<sup>63</sup> For more details, see section 40-190 of the *ITAA 1997*.

<sup>64</sup> *Ibid*.

<sup>65</sup> See Mark Hirschey and Jerry J. Weygandt, 'Amortization Policy for Advertising and Research and Development Expenditures' (1985) 23 (1) *Journal of Accounting Research* 326.

It is obvious that the taxation of IP transactions is subject to asymmetrical and debatable tax provisions. Moreover the literature is more concerned with developed rather than developing countries. The literature here often focuses on the tax treatment within a single tax jurisdiction. However, carrying out a cross country analysis is more helpful. It shows the different approach for dealing with IP transactions and it helps to conclude some common features of the appropriate tax treatment of IP. For that purpose the coming section will review and analyse the tax treatment of IP in Australia as an example of developed countries and Egypt and India as examples of developing countries.

### **III ANALYSIS OF THE TAX TREATMENT OF LICENSING TRANSACTIONS UNDER THE AUSTRALIAN, EGYPTIAN AND INDIAN INCOME TAX LEGISLATION**

This analysis of the tax treatment of IP transactions covers legal provisions, precedents and rulings that are related to the taxation of IP transactions. Those transactions are licensing, transfer, self-developed IP and IP transactions of specific legal entities, as explained previously. The focus here is on the domestic IP transactions which are carried out among domestic partners. They are companies which are resident of the relevant tax jurisdiction, or a foreign corporation which has a permanent establishment. The outcome of IP transactions will only influence the corporate income tax liability under the assumption that the corporate body is a recipient or payer of royalty income and transfer consideration.

The analysis is carried out in accordance with the Australian *ITAA 1936* and *ITAA 1997*,<sup>66</sup> the Egyptian *ITL 2005*,<sup>67</sup> and the Indian *ITA 1961*.<sup>68</sup> The analysis here aims: (i) to compare the tax treatment of IP transactions in these countries as examples to developed and developing countries and (ii) to assess their tax treatment of IP in terms of protection of tax revenue and encouraging self-developed IP in accordance with the previous section.

#### ***A The Tax Treatment of IP Licensing Proceeds***

The discussion of the tax treatment of IP licensing in developed and developing countries aims to assess the capability of the income tax legislation thereof to define and

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<sup>66</sup> The marginal tax rate for a corporation under *ITAA 1936* and *ITAA 1997* is 30 percent. This is multiplied by taxable income which is the difference between assessable income and allowable deductions. The Australian income tax legislation grants a number of deductions and exemptions which makes the average effective tax rate lower than the marginal rate. In this context Mintz calculated the average effective tax rate for Australia which was around 27 percent in 2007. For more details see Jack Mintz, '2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform' (2007) 254 *Journal C.D. Howe Institute Commentary* 1.

<sup>67</sup> The marginal tax rate for corporations is 20 percent, under *ITA 2005*. Nevertheless, the Central Bank of Egypt and Suez Canal Authority are subject to a 40 percent tax rate. Moreover, petroleum extracting and exploitation companies are subject to a 40.55 percent tax rate. It is claimed that the *ITL 2005* is more neutral and there are not many tax deductions and allowances from taxable income. However, the average effective tax rate calculated by Mintz was around 11 percent: Jack M. Mintz, *ibid*.

<sup>68</sup> The marginal tax rate for corporation under the Indian *ITA 1961* is 30 percent. This is multiplied by assessable income which is the difference between taxable income and allowable deduction. The Indian income tax legislation grants a number of deductions and exemptions which makes the average effective tax rate lower than the marginal rate. In this context Mintz calculated the average effective tax rate for India at around 28 percent in 2007. For more details see Jack Mintz, *ibid*.



determine the income that arises from licensing properly. Accordingly, a review of the relevant tax provisions within the Australian, the Egyptian and the Indian income tax legislation is provided below.

Income which arises from a licensing transaction is royalty income in accordance with the royalty definition provided by s 6(1) of *ITAA 1936* and s 995 of *ITAA 1997*.<sup>69</sup> The definition covers various types of royalty payment whether it is periodical or a lump sum payment. In addition it covers various types of IP business transactions whether licensing or transfer of various types of IP subject matters. Accordingly, licensing income in the hands of the licensor is considered ordinary income in accordance with s 6(1) of *ITAA 1997*. This income is also considered an assessable income when it arises from compulsory licensing since the definition of royalty mentioned in relation to licensing in general covers any type of licensing of property rights for use by a licensee.

This income should be included within a taxpayer's assessable income as an ordinary income of property. It may also be a part of statutory income in accordance with s 15-20, when it is not within the domain of s 6(1).<sup>70</sup> This shows that the royalty income is included within assessable income either as ordinary income or statutory income, when that income falls within the meaning of royalty.<sup>71</sup>

The timing for income recognition is an important factor for taxing royalty income in the hands of recipient. Section 6(1) of *ITAA 1997* stipulates taxing income when it is derived. The derived income may be either accrued or received income. Accrued income arises where the accrual basis is the determinant of taxable income: any prepayment or post payment are not considered for taxing income. Therefore, when the licensed rights of IP are being used by a licensor this determines the accrued income. On the other hand, received income arises where the cash basis is implemented, which means the royalty income is taxable when it is received. The court cases often tend to implement the accrual basis in commercial transactions which is consistent with financial accounting practices.<sup>72</sup> Accordingly, the royalty received from a resident is taxable as on the accrual basis when it is a part of commercial transaction.

The Egyptian *ITL 2005* considers a royalty as a source of income in the hands of the recipient. In this respect, Art. 3J provides that any income that arises from licensing,

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<sup>69</sup> According to s 6(1) a royalty/ royalties include(s) "any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for -

(a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade-mark, or other like property or right;

(b) the use of, or the right to use, any industrial, commercial or scientific equipment;

(c) the supply of scientific, technical, industrial or commercial knowledge or information;

(d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c); (da) the reception of, or the right to receive, visual images or sounds, or both, transmitted to the ..."

<sup>70</sup> See Frank Gilders et al, *Understanding Taxation Law 2010: and Interactive Approach* (Lexi Nexis Butterworth, 4<sup>th</sup> ed, 2010) 160.

<sup>71</sup> *Ibid.*

<sup>72</sup> See Frank Gilders, et al, above n 70, 169-170.



lease, or royalty payments from a resident licensee to a resident licensor is taxable income in the hands of the licensor. Moreover, Art. 1 (Para 12) defines a royalty as:

Any consideration paid in return for the use of copyrights related to literary, artistic or scientific work, including cinema movies and the use of any patent, trademark, design layout, model plan, secret formula or the right to use scientific, commercial or industrial equipment or information related to scientific, commercial or industrial expertise.

The word as it is used here is more comprehensive than just licensing or transfers of rights which are often carried out in accordance with contracting terms. It encompasses using IP subject matter under a contract and without a contract. At the same time, the royalty definition covers a royalty payment whether it is related to the licensing or transfer of IP or any other intangible property.

The above definition includes various sources of royalty sourced in Egypt, when it is within the meaning of royalty. Accordingly, a licensor is obliged to include a royalty received or accrued in taxable income. Taxable income of a juridical person (e.g. corporations), includes business income which arises from various business transactions including capital gains. Consequently, the licensing of IP (e.g. patents) is considered a type of business transaction which yields taxable business income. Moreover the licensing proceeds of compulsory licensing and infringement awards are taxable under that definition of royalty income.<sup>73</sup>

With regard to the timing issue of royalty income, since the royalty income is derived from business transactions that are carried out by a legal entity, this income is taxable on an accrual basis. The Egyptian *ITA 2005* clearly stated that the accounting profit, which is prepared in accordance with the Egyptian accounting standard, is the basis for working out taxable income. Accordingly royalty income received by a resident is taxable when it is accrued.

The tax treatment of royalty income under *ITA 2005* has been improved compared with its tax treatment under the previous *Income Tax Law No 157* of 1981 (hereafter, *ITL 1981*). Under Art 111B (Third) of *ITL 1981*, royalty income from know-how, the disposition of any rights and similar transactions was subjected to withholding tax at 32 percent without any deduction and it was excluded from a company's tax base. Also, when a company releases losses from its businesses, its royalty income is taxable regardless of tax losses. An important matter in a comparison between the abolished and the current income tax legislation is that the current income tax defines the royalty concept clearly. It also identifies various sources of royalty income which covers various types of IP subject matters. Clarity of definitions is important in reducing tax disputes, and simplifying compliance issues.

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<sup>73</sup> There are no legal precedents related to royalty income in Egypt under the *ITL 2005*, because it was only recently introduced and implemented. Moreover, using legal precedent within the Egyptian tax system is not common except for the cases of Supreme Court. In this respect there are no famous court cases related to royalty income. This is shown in Seadek's discussion of royalty income. He relied on common law court cases to support his argument about the meaning of royalty income and its implementation. For more detail see in Arabic, Ramadan Seadek, *Interpretation and Implementation of the Conventions of Double Tax Treaties* (Helwan University Press, 2007) 443-469.

The Indian *ITA 1961* defines royalty income as a consideration paid whether as a revenue stream or as a lump sum, (a lump sum payment being chargeable under capital gains),<sup>74</sup> in return for licensing or granting rights related to using the IP.<sup>75</sup> Royalty payments accrue under a number of business transactions. Those transactions are laid down in s 9, and are; (i) transfer, (ii) imparting and (iii) use of IP, technical services and scientific knowledge. Those three types of transactions refer to various types of use of IP whether under a contract or not. So the objective of elaboration is to encompass various techniques to use IP. Moreover, it is obvious that royalty income arises from a number of sources, as well as licensing IP. A royalty received from licensing IP subject matter is taxable income. It must be included in the taxpayer's tax base.

Compulsory licensing and infringement awards are not included in the exempt income sources which are listed in s 10 of *ITA 1961*. In this regard, there is no specific treatment of those types of licensing income and consequently they are taxable as an ordinary royalty.

The income recognition rule for business income according to s 145(2) of *ITA 1961*, is based on accounting standards which itself use the accrual basis for measuring business income. Accordingly the royalty income derived from licensing IP to a resident taxpayer is taxable when it is accrued.

The above analysis reveals that both developed (Australia) and developing countries (Egypt and India) have suitable legal provisions to tax the proceeds of licensing IP business transactions. The tax treatment of the licensor of IP subject matter is similar in the three countries in terms of income recognition rules and inclusion within taxable income. Further similarity exists in the tax treatment of the proceeds of compulsory licensing and infringement awards. However, there are a number of significant differences. These are:

1. The Australian *ITAA 1997* and the Egyptian *ITA 2005* taxes the royalty income of both individuals and legal entities on an equal footing, while the Indian *ITA 1961* gives tax incentives only to individual licensors in two cases: (i) royalty income from compulsory licensing is fully exempt in accordance with s 80RRB(c), and (ii) up to INR 300000 of royalty income is tax deductible from an individual tax base, in accordance with section 80RRB(c). This Indian treatment aims to encourage self developed IP by individuals.
2. A royalty payment is subject to withholding tax or deduction at source in accordance with s 194J of *ITA 1961*. A licensee or a payer (a juridical person which is subject to Indian ITA) of a royalty is required to withhold 10 percent of the gross amount which is paid to a resident licensor,<sup>76</sup> under the condition that the royalty amount is above INR 20,000. The withholding tax approach supports taxation of IP and enables the tax authority to track IP business transactions which improve the measures of protecting tax revenue.

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<sup>74</sup> See GN Gopalrathnam, 'Intellectual Property and Income Tax', in Sudhir Raja Ravindran (ed), *Intellectual Property and Taxation* (LexisNexis- India, 2007) 21.

<sup>75</sup> CCH, *India Master Tax Guide (Income-Tax & Wealth) 2008/2009* (2<sup>nd</sup> ed, 2008) 31.

<sup>76</sup> Different rates are applicable with regard to a non-resident licensor. Those rates are laid down within the provisions of double tax treaties between India and other countries.

### ***B The Tax Treatment of Licensing Payments***

Protection of tax revenue requires also considering the right of the royalty payer (licensee) to deduct the royalty payment from taxable income. This is consistent with benchmark taxation rules as previously discussed. A royalty payment is considered a necessary expense in order to carry on the business operation, because the IP subject matter (e.g. patent) is an input for business operations.

In order to enable a licensee to claim a deduction for a royalty payment, the Australian *ITAA 1997* sets in place specific measures for the deductibility of business expenses. In this respect, section 8-1(1) identifies the general criteria for deductibility of business expenses. Section 8-1(1) states that:

You can deduct from your assessable income any loss or outgoing to the extent that; (i) it is incurred in gaining or producing assessable income or (ii) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

Business enterprises often use IP subject matter as an input in their business operations. For example a pharmaceutical company uses a patented process to produce a new medicine or drug, which is sold to generate an assessable income. Moreover, the production process could not be performed without the patented process. Accordingly, a royalty paid for licensing a patent is tax deductible according to the positive limbs criteria.

On the other hand, section 8-1(2) identifies when expenses are not tax deductible. It states that:

You cannot deduct a loss or outgoing under this section to the extent that: (i) it is a loss or outgoing of capital, or of a capital nature or (ii) it is a loss or outgoing of a private or domestic nature or (iii) it is incurred in a relation to gaining or producing your 'exempt income' or your 'non assessable non-exempt income, or (iv) a provision of the Act prevents you from deducting it.

In order to ensure correct deductibility of a royalty payment, it must not fall into any of the negative limbs. In this respect, the royalty paid by a pharmaceutical company, in this example, is a type of recurrent expenditure. It is related to the business, it is incurred for producing taxable/assessable income. It meets the criteria for deductibility under s 8-1(1).

*Art. 22* of the Egyptian *ITA 2005* provides general rules for tax deductible expenses.

They are:

- i. The expenses shall be related to the business activity and it is necessary to run the business.
- ii. It must be a true expense and supported by relevant documents.

Accordingly, this type of royalty payment is generally a tax deductible expense which is deductible from a taxpayer's tax base.

The same tax treatment of a royalty payment is also given within the provisions of the Indian *ITA 1961*. In this regard, *ITA 1961* provides the rules for deductible expenses. Those rules are applicable to various types of expenses as well as to a royalty payment. Sections 30 to 36 enumerate specific expenses, which may be deducted from taxable income. Because the existence of an exhaustive list of deductible expenses is impractical, s 37 gives general rules for deductible expenses.<sup>77</sup>

The above discussion shows that in the three tax jurisdictions the tax treatment of a royalty payment is similar. However, the issues of treating a royalty payment as either a revenue expense or a capital expense may arise in the case of exclusive licensing which is similar to transfer which will be discussed in the following section. In this respect, the judicial precedents may be used as guide to the licensee, especially in the case of Australia and India as common law countries.<sup>78</sup> For example, the Indian Supreme Court in *CIT v. IAEC (Pumps) Ltd* stated that 'The amount paid by the taxpayer to a foreign company for granting a license to use its patents exclusively in India for a period of ten years with the intention of renewing it further would be revenue in nature'.<sup>79</sup> This case shows that even though the royalty payment was a lump sum and the patent was exclusively licensed, which would normally have made the case equivalent to a transfer, the possibility of renewal of the contract led the court to treat the case as a licensing transaction rather than a transfer, and consequently the royalty payment was considered a recurrent expense.

When the expense is tax deductible, it is subject to the similar rule of income recognition for tax purpose as previously discussed. The discussion showed that the three countries often tend to use the accrual basis for recognising royalty income as taxable income, accordingly the same principle is applied to the deductibility of a royalty payment when it is accrued.

#### **IV ANALYSIS OF THE TAX TREATMENT OF TRANSFER TRANSACTIONS UNDER THE AUSTRALIAN, EGYPTIAN AND INDIAN INCOME TAX LEGISLATION**

##### ***A The Tax Treatment of Transferors***

Tax legislation often distinguishes between a taxpayer who carries out commercial or industrial business activities and other taxpayers. In addition, tax legislation usually distinguishes between depreciable capital assets such as tangible assets (plant and equipment) and non depreciable assets such as shares which do not play a structural role in the business operations of a taxpayer. In this respect, two approaches are often employed by a tax legislator to deal with capital gains: either to tax them separately or to treat them as ordinary income. Those approaches are based on the purpose of holding the capital asset. It must be determined whether it is used in a profit oriented

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<sup>77</sup> For more details with regard to deductible expenses under s 37, see CCH, above n 75, 144–148.

<sup>78</sup> See Chandrasekaran Premasai and Natshanth Patil, 'India: Intellectual Property (Direct and Indirect) Taxation' (2008) 14(1) *Asia Pacific Tax Bulletin* 48, 49-50.

<sup>79</sup> *Ibid* 50.

business or for personal use. In the latter case, it is often treated separately, while in the previous case it is often treated as a part of assessable income.<sup>80</sup>

A separate tax treatment for capital gains often involves granting a concession to the eligible taxpayer in order to deal with some economic issues such as inflation.<sup>81</sup> This treatment is designed particularly for investment assets, such as investment in rental property or on the stock market. On the other hand, depreciable assets, which are used in business activities, are often excluded from capital gains tax.<sup>82</sup>

A capital gain that arises from the disposal of a depreciable asset is normally treated as ordinary income via the balancing adjustment provisions. Therefore, capital gains that arise from the transfer of IP subject matter that are used in business are included as ordinary income. On the other hand, IP subject matters are excluded from CGT. The consideration amount paid for disposition or transfer of IP is considered royalty income which is statutory income according to s 15-20, ITAA 1997.<sup>83</sup>

The addition of capital gains to statutory income might be subject to specific conditions or deferment of tax treatment, such as a 50 percent reduction of capital gain in assessable income or rolling over of the gain, if the consideration obtained has been invested in another similar asset. Nevertheless, when an Australian company transfers IP for specific consideration (royalty), the capital gains derived is added to assessable income as a statutory income without any deduction.<sup>84</sup>

Various approaches are used to deal with capital gains. However two important elements must be identified clearly. Those are the consideration and the cost base. Consideration for a transfer/sale of IP subject matter is the amount paid by the transferee in return for outright use of IP. Consideration must be determined in accordance with arm's length terms.<sup>85</sup> This is an important condition, particularly when the transfer occurs among associated parties. In this case, there is a doubt about the value of consideration where it might deviate from arm's length price.

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<sup>80</sup> For example in Ireland, capital gains realized by a company may be treated either according to capital gains provisions or according to corporate income tax. The previous treatment is applicable only to capital gains driven from disposal of land, while the latter treatment is applicable to the capital gains that are driven from the disposal of various assets. For more details see Irish Revenue Authority, 'Guide To Capital Gains Tax' (2004). It is available online at <<http://www.revenue.ie/leaflets/cgt1.pdf>>

<sup>81</sup> May argues the proper tax treatment for capital gains must deal properly with the causes of capital gains which may be one of the following:

- i. changes in absolute value due to natural growth or similar causes,
- ii. changes in the relative value of property in comparison with other property, due to external causes, and
- iii. changes in the money value of the property due to depreciation or appreciation of currency.

See George O. May, 'Taxation of Capital Gains' (1922) 5(34) *Journal of Accountancy* 321, 331

<sup>82</sup> CGT of depreciable assets which are subject to balancing adjustment events of businesses are subject to CGT separately, according to section 104-235 of ITAA 1997.

<sup>83</sup> Frank Gilders et al, above n 70, 219-225.

<sup>84</sup> Ibid 772.

<sup>85</sup> Lee Burns and Richard Krever, above n 18, 651.

With regard to the cost base, tax legislation gives general principles, which are applicable to various types of capital assets whether they are intangible or tangible assets.<sup>86</sup> For example working out the cost base of IP, e.g. patent, will be as follows: (i) the royalty paid for a transferor is considered the first cost element, (ii) consultation and legal fees and other related expenses are the second cost base element, (iii) when a transferee borrows for financing a royalty payment, the interest incurred is considered the third cost element, (iv) when a transferee carries out further R&D activities in order to develop the transferred patent, the R&D expenditure is considered the fourth cost base element, (v) the registration fees paid for transferring the IP in order to protect the rights of the transferee is considered the fifth cost base element. The total amount of these costs represents the cost base of the CGT event which should be deducted from the received consideration when it is transferred to a third party.

There is no separate tax treatment for capital gains under the Egyptian *ITL 2005*. It considers capital gains arising from depreciable assets as part of ordinary taxable income, in accordance with Art 17 and 51. When IP subject matter is being used in business operations, it is considered a depreciable asset. Consequently, any capital gains that arise from the transfer of any IP subject matter is treated as ordinary income and included in the income tax base. This treatment is totally different than the previous treatment under the repealed *ITL 1981* which taxes transfer consideration whether as a lump sum or a stream of revenues as income from mobile capital, as previously explained.

The Indian *ITA 1961* has a specific tax treatment of capital gains, which complicates the matter, especially when it deals with non-depreciable assets or transactions arising outside the ordinary course of business. However, tax legislation tends to simplify the rules with regard to depreciable assets which are used in business operations. Accordingly capital gains arising from depreciable assets are included in the assessable income of a company.

Assessing the tax treatment of transfer proceeds of IP is important to assess the capability of tax provisions in protecting the tax base. In this respect, in the three countries, they consider that IP subject matter as a depreciable asset and consequently the realised capital gains from outright disposal of IP is treated as ordinary income. This treatment protects tax revenues; nevertheless, it may discourage a transfer of self-developed IP to a third party or spin-off company. With regard to the former, the full amount of consideration is taxed as a capital gain, while in the latter it is taxed as

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<sup>86</sup> Section 110-25 of *ITAA 1997* identifies five elements of cost base:

- i. The first element is the total of (a) the amount you paid or are required to pay, in respect of acquiring it, and (b) the market value of any other property you gave, or are required to give in respect of acquiring it.
- ii. The second element is incidental costs you incurred.
- iii. The third element is the costs of owning the CGT asset you incurred, such as interest on money you borrowed to acquire the asset; and costs of maintaining, repairing or insuring it; rates or land tax, if the asset is land.
- iv. The fourth element is capital expenditure you incurred; (a) the purpose or the expected effect of which is to increase or preserve the asset's value; or (b) that relates to installing or moving the asset, and
- v. The fifth element is capital expenditure that you incurred to establish preserve or defend your title to the asset, or a right over the asset.



unrealised gains. Accordingly, specific consideration is required to balance between protection of tax revenue and encouragement of self-developed IP.

### ***B The Tax Treatment of Transfer Payments***

The transferee acquires a new capital asset in return for incurring significant costs, which are known as acquisition costs. In this regard, the tax treatment of capital costs is a significant matter. Amortisation of acquisition costs of transferred IP over a specific period is consistent with the accounting matching principle, as previously explained.

Amortisation of acquisition costs of IP is provided for under specific conditions in Australia. In this respect, s 40-30 (1) of *ITAA 1997* identifies depreciable assets. A depreciating asset is defined as 'an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used, except: (1) land, (2) an item of trading stock, and (3) an intangible asset, unless it is mentioned in subsection s 40-30(2)'.<sup>87</sup> In this respect, depreciable intangible assets are identified as, ; (i) mining, quarrying or prospecting rights; (ii) mining, quarrying or prospecting information; (iii) items of intellectual property; (iv) in-house software; etc. Accordingly, this section states that items of IP are depreciable assets. Those items are defined in section 995-1 of *ITAA 1997*. They are the rights that an entity has as (i) the patentee, or a licensee, of a patent; or (ii) the owner, or a licensee, of a registered design; or (iii) the owner, or a licensee, of a copyright. Consequently, amortisation is only allowed for specific items of IP, namely patents, registered designs and copyrights.

Trademarks, trade secrets, and undisclosed information are excluded from being depreciable assets. In defending this tax treatment Rider et al argued that 'the fact that trade secrets, know-how and confidential information are not a form of property, in the conventional legal sense, leads to confusion in determination of their taxation treatment'.<sup>88</sup> This view represents a legal viewpoint. Nevertheless, it does not justify the denial of amortisation of purchased trademarks, know-how and confidential information. It only justifies the denial of amortisation for self-developed know-how, trademarks, and confidential information. A purchaser of those IP items incurs a significant amount of acquisition costs. Those items also participate in generating taxable income. At the same time, this tax treatment conflicts with the accounting treatment of purchased goodwill, which is broader than trademarks. Australian Accounting Standard No 18 allows a deduction for amortisation of purchased goodwill using the straight-line method up to 20 years.<sup>89</sup> Accordingly, the tax treatment discourages taxpayers from acquiring those items of IP that are not amortisable under tax law.

With regard to the amortisation method, the uniform capital allowance provisions were introduced to the Australian *ITAA 1997* in 2001.<sup>90</sup> They allow the use of two methods

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<sup>87</sup> Section 40-30 of the *ITAA 1997*.

<sup>88</sup> Cameron Rider, et al, above n 10, 23.

<sup>89</sup> See Michael Walpole 'Proposals for the Reform of the Taxation of Goodwill' (PhD Dissertation, University of New South Wales, Sydney - Australia, 2006), 164-165.

<sup>90</sup> There are a number of depreciation methods which are similar to accounting methods which are used in calculating depreciation/amortisation. Also they are often applicable to various assets. Those methods are;

i. Straight line method,

for depreciation of depreciable assets, the prime cost method which is similar to a straight-line method, or the diminishing value method. With regard to IP, the only applicable method is the prime cost method.

Determining the cost base of a depreciable asset for amortisation purposes is an important matter. Tax legislation uses historical cost.<sup>91</sup> For example, the Australian *ITAA 1997* identifies the elements of the cost base that are applicable to any type of depreciable asset. There are two elements.<sup>92</sup> The first element cost is the cost incurred to acquire the assets, while the second element costs are the costs incurred after acquiring the asset.

The useful life of a depreciable asset is determined according to the expected economic life of the asset. With regard to IP, it is known that the useful life of any item is determined by specific legislation. For example the patent term according to the TRIPS agreement is 20 years. Therefore the economic useful life of a patent is 20 years. In line with that, s 40-95(7) of *ITAA* uses the statutory effective life for various types of patents and registered designs. However, a trademark has no definite useful life. As a result, the United States and Australian tax legislation deny an amortisation deduction for trademarks.<sup>93</sup>

Under the Egyptian *ITL 2005*, amortisation of acquisition costs of transferred IP within a specific period is consistent with the accounting matching principle, as mentioned previously. This accounting treatment is set in place under the Egyptian Accounting Standard No 23 (hereafter, EAS).<sup>94</sup> Moreover, according to *ITA 2005*, the accounting profit is the basis for working out taxable income. Nevertheless, the tax treatment for amortisation of IP subject matter deviates from accounting treatment.

With respect to the tax treatment of IP acquisition costs, Art. 25(2) of *ITL 2005*, allows a 10 percent amortisation allowance, including purchased goodwill. The straight line method is used. The acquisition cost is amortised over ten years. This tax treatment is newly introduced within the provisions of *ITA 2005*. Under the repealed *ITL 1981*,

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- ii. declining balance method
  - iii. Income forecast method, and
  - iv. Pooling of assets
  - v. Safe harbor

For more details see, see Carol Conjura et al, 'To Capitalize or Not? The INDOPCO Era Ends with Final Regulations under Section 263(a)' (2004) 100(4), *Accounting and Tax Periodicals* 215.

<sup>91</sup> There are a number of approaches to evaluate the IP subject matters, such as the historical cost approach, income approach, real option approach and others. Such methods are being used for various purposes, however here the main concern is the tax purpose which relies on the historical cost for working out the amortisation amount.

<sup>92</sup> See Rodney Fisher, 'Capital Allowance: the New Uniform Regime' 2002 5(2) *Journal of Australian Taxation* 263, 278.

<sup>93</sup> In Europe, amortisation of intangible assets is allowed only with respect to intangible assets with a finite life. Does this imply that those IP subject matters with infinite life, such as trademarks and undisclosed information, are not eligible for the depreciation allowance? For more details see, European Commission – Common Consolidated Corporate Tax Working Group 'Intangibles Assets and Tax Depreciation', Brussels, 21 February 2005. <

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/CCCTBWP5Intangible\\_assets\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP5Intangible_assets_en.pdf)> at 20 Sep. 2008.

<sup>94</sup> For more details see EAS No. 23, paragraphs 97/106.

depreciation allowances were tax deductible under Art 114 (5) however eligible assets and depreciation rates were governed by administrative rulings. In this regard neither administrative ruling 6/1986 nor 85/1997 had allowed depreciation for any intangible asset.

The Indian ITA 1961 provides a depreciation allowance for both tangible and intangible assets in accordance with s35 ITA 1961. According to this provision, various types of IP subject matters are eligible for depreciation. Those assets are aggregated into two blocks of asset (BOA) groups. One is for tangible and the other for intangible capital assets. The total value of the BOA is known as the written down value (WDV).<sup>95</sup> The consideration or value of any new item of IP is added to the WDV and any proceeds from selling an IP item is deducted from it. The net of the WDV is multiplied by the depreciation rates which are provided in Appendix I of Tax Rule No 5 (ITA 1961). The intangible BOA is depreciated at the rate of 25 percent of WDV. Nevertheless, in a number of cases the Indian High Courts and Supreme Court have allowed immediate depreciation of lump sum payments relating to the transfer of IP. For example, in *CIT v. British India Corporation Ltd*, the Supreme Court held that the lump sum payment related to a trade mark could be expensed immediately. In *Alembic Chemical Works Co. Ltd v CIT* it was held that the lump sum payment related to know-how was a current expense.<sup>96</sup> These judicial precedents encourage companies to acquire modern technology and to be involved in extensive R&D activities.

The above discussion shows that under the Australian ITAA 1997, a capital allowance for specific items of IP subject matters is tax deductible while it is not allowed for other items of IP. Moreover, the treatment in terms of depreciation methods and rates are not generous. Similarly the Egyptian newly introduced depreciation allowance for the acquisition costs of IP uses a straight line method and a low depreciation rate. However, the Egyptian legislation is a newly introduced provision and it might be good as a starting point. Nevertheless, a comparison between the Australian and the Egyptian capital allowance on the one hand, and the Indian capital allowance for tangible assets on the other hand, shows that the latter is more generous. In this respect Indian ITA 1961 provides a favourable tax treatment for intangible assets in comparison with tangible assets. The BOA of intangible assets is depreciated at 25 percent of the WDV while the tangible BOA is depreciated at 15 percent.<sup>97</sup> Moreover, the judicial precedents sometimes go further in encouraging acquisition of IP through allowing a 100 percent depreciation rate of acquired IP. Such legal power is not available under the Egyptian legal system as a civil law country in which courts could not go beyond the legal provisions.

The acquired IP subject matter may be benefited through using it in carrying out R&D activities or in improving production process and technology transfer. Ultimately, those activities may lead to the development of new IP. Accordingly, specific amortisation scheme is required to encourage the use of new IP subject matters (e.g. patent and know-how). The previous discussion of the tax treatment of acquisition costs through allowing depreciation or amortisation showed the following:

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<sup>95</sup> For more details about Written Down Value (WDV) of the capital asset see s 43(6).

<sup>96</sup> For more details see Chandrasekaran Premsai and Natshanth Patil, above n 78, 50.

<sup>97</sup> For more details see, s 35, Indian ITA 1961.

1. The Australian *ITAA 1997* allows a deduction of capital allowance related to specific items of IP subject matter and denies it for other items, such as trade secrets and know-how. Moreover, it uses a prime cost method (straight-line) method for depreciating IP subject matter, and the useful life is determined by administrative rules. It is important to use a generous amortisation scheme which encourages using IP and it is important to include various items of IP rather than specific items.
2. The Indian *ITA 1961* provides a generous amortisation scheme for intangible assets. The BOA of intangible assets is amortised at 25 percent (using a declining balance method). This type of treatment encourages businesses to use modern technology which improves productivity and the level of economic growth. Moreover, IP capital expenditures which constitute a part of R&D are a 100 percent tax deductible. Indian court cases as previously explained allowed 100 percent deduction of IP even though it was for capital assets in many cases. By contrast, the Egyptian *ITL 2005* provides for depreciation of intangible assets which include IP on a straight line basis at 10 percent.

## **V THE ANALYSIS OF THE TAX TREATMENT OF SELF DEVELOPED IP UNDER THE AUSTRALIAN, EGYPTIAN AND INDIAN INCOME TAX LEGISLATION**

### ***A The Tax Treatment of R&D Expenses***

The tax system plays an important role in stimulating R&D which leads to the development of domestic IP subject matters. Many developed and a few developing countries have paid attention to the necessity of tax incentives to stimulate R&D activities. The discussion below reviews the experiences of Australia, Egypt and India.

The current R&D tax treatment in Australia commenced in the mid-1980s when the *Industry Research and Development Act 1986* was introduced. Sections 73B to 73Z of the *ITAA 1936* contain the measures granting R&D tax incentives. Those measures identify the objectives of R&D tax incentives, and the techniques to achieve those objectives,<sup>98</sup> by identifying the method of delivering tax incentives, eligible taxpayers and activities. The R&D tax incentives are based on using a tax allowance rather than a tax credit. The *ITAA 1936* provides a R&D tax allowance as a tax incentive for R&D expenditure. Eligible companies can claim a 125 percent deduction for R&D expenditure. In addition, an extra 50 percent is available to companies that increase their level of R&D expenditure.

There are two levels of R&D tax allowances. The primary level provides a further 25 percent deduction for R&D expenditure, whether it is current or capital expenditure, as

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<sup>98</sup> In this respect, s 73B of the *ITAA 1936* identifies the objectives of this treatment as follows:

- (a) Encouraging the development by eligible companies of innovative products, processes and services; and
- (b) Increasing investment by eligible companies in defined research and development activities; and
- (c) Promoting the technological advancement of eligible companies through a focus on innovation or high technical risk in defined research and development activities; and
- (d) Encouraging the use by eligible companies of strategic research and development planning; and
- (e) Creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies.

an incentive toward R&D. On the other hand, the incremental allowance gives an additional 50 percent deduction for current expenditure only, in accordance with s 73QA(2) of the *ITAA 1936*. For a company to be eligible for an incremental deduction, it must realise an increase in R&D expenditures above the average R&D expenditures in the previous three consecutive years in accordance with s 73QA(1) *ITAA 1936*.

An R&D tax incentive regime needs to identify eligible R&D activities, eligible expenditures and eligible taxpayers. Identifying eligible activities is the starting point for eligibility of the R&D tax incentives. It is important to identify what are eligible activities and whether the definition is based on the Frascati Manual or a different guide. Section 73B (1) *ITAA 1936* defines R&D activity as:

- a) Systematic, investigative and experimental activities that involve innovation or high levels of technical risk and which are carried on for the purpose of:
  - i. Acquiring new knowledge (whether or not that knowledge will have a specific practical application); or
  - ii. Creating new or improved materials, products, devices, processes or services; or
- b) Other activities that are carried on for a purpose directly related to the carrying on of activities of the kind referred to in paragraph (a).

It is obvious that the definition is mainly concerned with those activities which relate to basic research, applied research and experimental research. Those activities have a high level of risk and lead to acquiring knowledge and to creating innovations.

There are two more elements associated with the scope of R&D incentives, the definition of the types of expenses and the definition of eligible taxpayers. As explained above, the Australian tax allowance (basic allowance of 125 percent) covers various types of expenditures: current expenditures, such as salaries, contract expenditures (in the case of outsourcing of R&D), feedstock and others.

The eligible taxpayers for the R&D tax allowance deduction are determined by s 73L of the *ITAA 1936*. Those taxpayers must register at the Industry Research and Development Board (IRDB), which was incorporated under the *Industry Research and Development Act 1986*. In order to be eligible for registration with the IRDB, a company must meet a number of criteria.<sup>99</sup>

There is a threshold for a company's R&D expenditure to be claimable. This threshold means that the total amount of R&D expenditure must be above A\$20,000 in a taxable year, whether it is carried on in-house or outsourced. To claim a deduction for the extra 50 percent, the company must initially be eligible to claim the 125 percent deduction.

The current Australian R&D tax incentives were introduced in 1986 within the provisions of the *ITAA 1936*. They have been amended many times in order to make them more efficient and effective. However, there is no time limit for their implementation, which gives assurance to private business that the incentives are

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<sup>99</sup> AusIndustry, *Guide to the R&D Tax Concession*, July 2008, Part B: Research and Development Activities, 6, <<http://www.ausindustry.gov.au/innovationandrandd/randdtaxconcession/pages/guidetotherdtaxconcession.aspx>> at 19 June 2009.



continuous, encouraging them to be involved in long-term R&D projects. On the other hand, using a R&D tax allowance gives the opportunity to businesses to carry forward any losses that arise from business activities or as a result of deducting the R&D tax allowance.

The tax treatment under the Egyptian *ITL 2005* for current expenditure is generally consistent with the accounting treatment according to Art.17 (Para 2) which states that 'net profit is determined based on the income statement prepared according to the Egyptian Accounting Standards. The tax base is determined by applying the provisions of this law to the net profit'. Accordingly, there is no specific treatment of R&D within the provisions of the *ITL 2005*, despite the specific nature of R&D activities. The EAS No. 23 sets an accounting treatment for intangible assets.<sup>100</sup> It distinguishes between research expenses and development expenses. The first are treated as current expenditures while the latter may be treated as either current expenditures or capital expenditures. In order to be treated as a capital expenditure, it must satisfy six conditions: (i) the company has carried out a pilot study for developing an intangible asset, (ii) the company intends to develop the intangible asset completely, in order to use or sell, (iii) the company has the ability to use or sell the developed asset, (iv) there is certainty with regard to the success of the project, (v) there is a certainty with regard to the potential benefits, and (vi) the company has the ability to measure the development costs separately. These conditions are difficult to satisfy with regard to R&D projects since R&D projects have a high degree of uncertainty. Therefore, the development expenses are treated as current expenditure in accordance with a conservatism principle.<sup>101</sup> However, this treatment is only valid before the recognition of the intangible asset. Any expense incurred after the recognition shall be capitalised according to EAS 23.

Capital expenditure covers the depreciation allowances of scientific apparatus, lab fixtures, buildings, patents, etc. There are no specific provisions for a depreciation allowance of R&D equipment. They are subject to the general rule of depreciation which is set out in Art. 25.<sup>102</sup> It provides a favourable tax treatment for machinery and equipment. This treatment of fixed assets encourages companies to acquire new assets and the most advanced technology. This favourable treatment of fixed assets depreciation may have a positive impact on those companies that carry out R&D projects too.

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<sup>100</sup>Egyptian Accounting Standards was issued in 1997 according the decree of the Minister of Economics, and they were updated in 2006 by a new decree of the Minister of Economics No 243/2006 (Arabic), <[http://www.cma.gov.eg/cma/content/arabic/accounting\\_criteria/accounting\\_criteria.htm](http://www.cma.gov.eg/cma/content/arabic/accounting_criteria/accounting_criteria.htm)> at 20 October 2008.

<sup>101</sup> Stephen H. Penman and Xiao-Jun Zhang, 'Accounting Conservatism, the Quality of Earnings, and Stock Returns' (2002) 77(2) *The Accounting Review*, 237.

<sup>102</sup> It states three depreciation methods that are applicable to any capital asset regardless of its type of business usage. Those are;

- i. Straight-line method, used for buildings (5 percent annually) and intangible assets.(patents are written off within 10 years).
- ii. Accelerated depreciation, for computers (50 percent), and
- iii. A pooling of asset method, pursuant to which all other assets are added together and depreciated at 25 percent annually. In addition any new asset added to the pool for the first time, whether it is new or used, is eligible for a 30 percent deduction and then the net value is added to the pool.



The Indian *ITA 1961* provides specific tax treatment of R&D activities. In this respect, s35 is applicable only to R&D expenses. It sets specific rules for the deductibility of R&D expenditures. Those rules cover both current and capital expenditures associated with R&D activities. Current expenditures of R&D are generally tax deductible. There are four types of deductions for current R&D expenditure. Under the first type 100 percent of R&D current expenditure is tax deductible. The second type is a 125 percent weighted deduction when it is paid for carrying out R&D by an Indian company that is mainly carrying out R&D activities, upon the condition that the project has been approved by a prescribed authority. The third type of deduction is effective in 2009/2010 and applies a deduction of 125 percent of the amount paid to a third party (specific scientific institutions) to carry out specific research projects on behalf of the assessee in accordance with s 35(2AA), upon the approval of the prescribed authority. The fourth type of deduction is related to R&D expenses of specific businesses which are biotechnology, manufacture or production of any drugs, pharmaceutical, electronic equipment, computers, and telecommunication equipment. These businesses are allowed a deduction for R&D expenditures at 150 percent of actual expenses, under specific conditions, which are laid down in s 35(2AB) (1). It is obvious that current expenditures of R&D have a favourable tax treatment. This type of tax treatment encourages businesses to be involved in more R&D activities.

Moreover, capital expenditures related to R&D enjoy a favourable tax treatment. In this context, capital expenses such as the acquisition costs of equipment, apparatus and other scientific devices as well as IP which are used in scientific research are wholly deductible in the year of acquisition if they are assigned to R&D activities. Therefore, the taxpayer is not allowed to claim depreciation for those capital assets under s 32. Acquisition costs of buildings and land which are used for a scientific purpose are not allowed according to s 35(2)(i). These are the general rules in India for deducting capital expenditures related to R&D.

### ***B The Tax Treatment of Other Expenses***

The R&D expenses are often expensed to develop a new product or process which may be patented, or produces know-how or a secret formula. However, other forms of IP, for example trademarks, are developed through advertising and other promotional activities. Deductibility of these expenses may be either within the domain of section 8-1 of the *ITAA 1997* (current expenditures) or within the domain of ss 40-825 and 40-880 (capital expenditure).

When it is not current expenditure, it raises the issue of the income/capital dichotomy. In this respect, Gilders et al have identified four criteria for determining whether the expenditure is current or capital in nature. These are:<sup>103</sup> Dixon's criteria from *Sun Newspapers*, (ii) 'mere realisation' from *California Copper Syndicate*, (iii) nature of consideration given from receipts, (iv) fixed and circulating capital. Those criteria are in accordance with subsections 8-1(1) and (2) of the *ITAA 1997*, which provide the positive and negative limbs as explained previously.<sup>104</sup>

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<sup>103</sup> Frank Gilders, et al, above n 70, 91.

<sup>104</sup> *Ibid*.

A similar approach exists under the Egyptian ITL 2005. According to EAS 23 (Para 63/64) any expense related to the development of a trademark is to be expensed on the current basis. This accounting treatment is acceptable under articles 17 and 51 of *ITL 2005*. This treatment is valid during the development process of IP subject matter. After recognition of a trademark, for example, any expenses incurred which relate to registration or legal fees, are capitalised and amortised in accordance with Art 25(2), as mentioned before.

The Indian *ITA 1961* provides that other expenses are often expensed on the current basis in accordance with s 37 of *ITA 1961*. Nevertheless, drawing a line between capital expenses and revenue expenses related to IP is not an easy task. In many cases, the tax authority treats expenses as capital expenses, which means they have to be amortised over a specific period. On the other hand, companies prefer to expense this type of expenditure on a 'current' basis. Therefore, those expenses related to IP may be problematic, which creates many tax disputes. In this situation there is not a conclusive measure to implement.<sup>105</sup> Therefore, identifying whether such expenses, particularly registration fees, are capital or current expenditure depends on the facts related to each case.

### ***C Assessing the Role of Tax Legislation to Stimulate Self-developed IP***

The discussion has revealed that a number of tax measures can be employed in relation to the development of IP. Those measures include the tax treatment of acquisition costs. In this context, below is a detailed analysis of the specific tax treatment for R&D activities.

The previous discussion of R&D tax incentives shows that there are two different approaches employed to deal with R&D expenditure in Australia, Egypt and India. Those approaches cover both current and capital expenditures. In this respect the differences are recapped below:

1. Under the Australian income tax regime; there are two levels of R&D tax allowances. The primary level provides a further 25 percent deduction for R&D expenditure, whether it is current or capital expenditure, as an incentive toward R&D. On the other hand, the incremental allowance gives an additional 50 percent deduction for current expenditure only, in accordance with s 73QA(2) of the *ITAA 1936*. For a company to be eligible for an incremental deduction, it must realise an increase in R&D expenditures above the average R&D expenditures in the previous three consecutive years in accordance with s 73QA(1) of the *ITAA 1936*. Nevertheless, the current system is under review, in order to improve it and achieve the desired objective efficiently. The proposed system provides a generous R&D tax incentive, where an 85 percent tax credit will be given to business. The first 45 percent will be non refundable while the remaining will be refundable.<sup>106</sup>

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<sup>105</sup> See GN Gopalrathnam, above n 74, 20-23.

<sup>106</sup> See Australian Government: Treasury, The new research and development tax incentive, (Consultation paper, September 2009), 1-2. < [www.treasury.gov.au/documents/1599/PDF/Consultation\\_paper\\_90916.pdf](http://www.treasury.gov.au/documents/1599/PDF/Consultation_paper_90916.pdf) > at 30 November 2009.

2. With regard to current expenditure, the Egyptian *ITL 2005* allows a deduction for R&D expenses in accordance with the accounting treatment. There is no specific tax treatment of R&D expenses. With regard to capital expenditures, the Egyptian *ITL 2005* does not mention depreciation of tangible and intangible assets, which are employed in scientific research.
3. On the other hand, the Indian *ITA 1961*, via s 35, allows a deduction of an R&D allowance under different ratios as explained previously. The R&D tax allowance reflects a friendly tax policy towards R&D activities. With regard to capital expenses, s 35(1)(iv), allows a 100 percent deduction of the capital costs used in scientific research which encourages businesses to use advanced technologies in R&D activities. Moreover, the Bill of the New Direct Tax Code 2009 maintains the tax incentives for R&D activities, despite a movement towards an elimination of many tax incentives.<sup>107</sup>

## VI TAX TREATMENT OF THE IP OF SPECIFIC BUSINESS TYPES

### *A The Tax Treatment of IP of Free/ Export Processing Zones*

There are a number of specific types of businesses which are developed for specific purposes. For example, free zones and export processing are commonly used in many developing rather than developed countries. This legal form does not exist in Australia; other legal forms are employed for different business activities as well as IP. In this respect, Rider et al, discussed in their study a number of legal forms which suit exploitation of IP, such as a spin-off company and pooled development funds (hereafter PDFs) and venture capital (hereafter VC).<sup>108</sup> In Australia, the *Pooled Developed Funds Act 1992* introduced PDFs in 1992, a legal form of business which enjoys a number of tax incentives under specific conditions.

The tax incentives granted to PDFs include a reduced tax rate on taxable income. In this respect income generated from venture capital is taxed at 15 percent and other income is taxed at 25 percent. Moreover, the capital gains generated from PDFs is tax free in the hands of partners. This legal form of business encourages, indirectly, investments by small and medium size enterprises (SMEs) in R&D activities which might lead to creation of IP.<sup>109</sup>

With respect to Egypt, even though the *ITL 2005* tends to levy tax on various legal forms of business undertakings, there are exceptional rules, which are created particularly for specific businesses or purposes. In this context, the Egyptian Investment Guarantees and Incentives Law No. 8 of 1997 (hereafter *IGIL 1997*) classifies investment projects as internal investment projects (onshore projects) or free zones projects (offshore projects). The former type is subject to income tax in the same way as any other businesses. The latter type enjoys absolute tax exemption.<sup>110</sup> Accordingly, IP business

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<sup>107</sup> See India: Ministry of Finance, Direct Taxes Code Bill, 2009, < <http://www.timesbuzz.com/2009/09/indias-direct-tax-code-bill-2009-with.html>> at 30 November 2009.

<sup>108</sup> See Cameron Rider, et al, above n 10, 38.

<sup>109</sup> Ibid.

<sup>110</sup> See Art.35 of *IGIL 1997*.

transactions are not taxable at all. This means that the ordinary income which arises from licensing and capital gains are exempted from income tax. In addition, if there is an IP holding company carrying out its business in free zones, its income is exempted from income tax forever.

With respect to the Indian tax legislation, there are a number of tax incentives for investment projects, working in export processing zones established under the *Export Processing Zones Act 1995* or special economic zones established under the *Special Economic Zones Act 2005*. Those business entities enjoy a number of tax incentives with regard to the exemption of export proceeds from income tax. Tax incentives include a 100 percent tax exemption for the first five years, followed by a 50 percent exemption for 2 years etc.<sup>111</sup> These kinds of tax incentives are not specific to IP transactions or the R&D therein. On the other hand, specific tax incentives are provided to those companies whose main business is scientific research. According to s 80-IB(8A), those companies enjoy a 100 percent tax exemption for a five year period on their income derived from scientific operations.<sup>112</sup> Those companies must register with a prescribed authority and meet the required conditions.<sup>113</sup>

### **B The Tax Treatment of IP of Venture Capital in R&D**

A venture capital entity is a common legal business form, which developed and developing countries set specific measures to encourage, such as the *Venture Capital Act 2002* in Australia. Under that law an important legal form can be established that is a Venture Capital Limited Partnership (VCLP). This legal form of business is suitable for specific type of business as well as IP activities.<sup>114</sup>

The VCLP enjoys a number of tax incentives under specific conditions. Those are: (i) exemption from capital gains, (ii) a discounted capital gain is provided to the partners of the VCLP, and (iii) specific tax rules for losses generated from the VCLP, which enables a partner to deduct their losses from other sources of income.<sup>115</sup>

A Venture Capital Company or business is a type of investment project which could be established under the Egyptian *IGIL 1997*. Accordingly, they were eligible for various types of incentives and guarantees. As a result of enacting *ITL 2005*, which eliminated various types of tax incentives, investment in venture capital is subject to income tax in the same manner as other businesses. Therefore there are no specific tax incentives for venture capital invested in scientific research.

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<sup>111</sup> For more detail see CCH above n 75, 184-185.

<sup>112</sup> In this regard s 80-IB(8A) mentioned that "The amount of deduction in the case of any company carrying on scientific research and development shall be hundred per cent of the profits and gains of such business for a period of ten consecutive assessment years, beginning from the initial assessment year, if such company

(i) is registered in India;

(ii) has its main object the scientific and industrial research and development;

(iii) is for the time being approved by the prescribed authority at any time after the 31st day of March, 2000 but before the 1st day of April 2007;

(iv) fulfils such other conditions as may

<sup>113</sup> For more details see *Ruling No 18DA of ITA 1961*.

<sup>114</sup> See Cameron Rider et al, above n 10, 38-40

<sup>115</sup> Ibid.

On the other hand, the Indian *ITA 1961* provides tax incentives for specific projects involved in R&D activities, such as biotechnology, pharmaceutical etc, if they are established as a Venture Capital Company (VCC)/Venture Capital Unit (VCU). Section 10(23AB) grants a tax exemption to any VCC or VCU which is involved in seed research and development, biotechnology, R&D of pharmaceutical companies, etc. A temporary tax exemption for 5 years is granted to those companies whose income is driven mainly from scientific research, under the condition that those companies are registered with the Department of Scientific and Industrial Research and Development (Ministry of Science and Technology, Government of India). This tax exemption is granted in accordance with s 80 IB (10). The objective of this tax exemption is to mitigate the high level of uncertainty associated with this type of business activity.

The above discussion reveals that both the Australian and the Indian tax policy-makers are aware of the role which the tax system can play to encourage scientific research and the consequent development of new inventions, innovations and processes. Such new outputs lead to the development of new IP subject matter which may take a number of forms such as new patented products or processes, new scientific knowledge/know-how, etc.

### ***C Assessing the Tax Treatment of Specific Business Entities***

There are a number of specific legal forms of business which are available to specific type of businesses as well as IP businesses in both Australia and Egypt. In Australia there are the *PDFs Act* and *Venture Capital Act*. On the other hand, the Egyptian *ITL 2005* gives an absolute tax exemption to those undertakings that are founded in the free zones under *IGIL 1997*. This creates a good opportunity for tax planning as previously explained for any business activity. On the contrary, the Indian *ITA 1961* provides specific tax exemptions to scientific institutions or venture capital projects under specific terms. It is obvious that the Indian legislator is more concerned with scientific research and those activities which create a high level of positive externalities to the economy in general.

These types of business entities are important to encourage self development and exploitation of IP. However, specific measures are required in these countries which streamline establishment of these businesses which are directly connected to IP, particularly in Australia and Egypt.

## **VII THE COUNTRY'S OVERALL TAX POLICY TOWARDS TAXATION OF IP**

The different tax treatments reflect a different approach to tax policy. The Australian tax policy makers are aware about the role of income taxation in stimulating R&D activities and possible development of new IP subject matters. This is reflected in granting tax incentives to R&D activities and the potential plans to improve R&D investment. However, it is important to pay more attention to other aspects which encourage development and exploitation of IP. This includes designing a new depreciation scheme for intangible assets in general, and particularly IP subject matter. Moreover, a generous package of tax incentives may be granted to those businesses specialising in R&D activities, and development of IP. This policy is a reflection of the efficiency criterion in dealing with market failure issues associated with self-developed IP.



On the other hand, the Egyptian tax policy is more concerned with broadening the tax base and lowering tax rates, which creates a neutral tax system. However, neutrality does not necessarily mean efficiency.<sup>116</sup> An efficient tax system has to address the different levels of market failure associated with each type of business activity.<sup>117</sup> It may be difficult to address various levels of market failure; however there is a consensus among the majority of developed countries and some developing countries that undertaking scientific research is associated with a high level of uncertainty and market failure. Therefore the tax systems in those countries try to provide specific tax treatment for scientific R&D. For example, see the cases of Ireland and Luxemburg.<sup>118</sup>

The Indian government has used this approach in providing a specific tax treatment for the development of IP (i.e. tax incentives for R&D expenditures) and for the use of IP (i.e. specific amortisation schemes for IP). Therefore, the Indian government pays more attention to the efficiency of their tax system. The importance of R&D activities has been confirmed also in the recent development of the Indian tax policy, through maintaining tax incentives related to R&D.

Moreover lowering tax rates and broadening the tax base is a type of tax competition which is known as “racing to the bottom” tax competition.<sup>119</sup> The question now for tax policy makers is what to do if neighbouring countries apply the same tax policy, or go further by making their tax rates lower than Egyptian tax rates. So a new mechanism for tax competition is needed and that mechanism requires providing specific tax treatment to scientific research which assists in developing domestic IP and encouraging foreign companies to invest in Egypt.

## VIII SUMMARY AND CONCLUSION

IP is an important factor in achieving economic development through technology transfer and creating positive externalities in national economies. The strong measures of IP protection resulting from the implementation of the TRIPS agreement encourages business undertakings involved extensively in IP. This situation addresses a number of tax issues with regard to the capacity of income tax legislation to deal properly with those IP transactions in both developed and developing countries, which reflects the adequacy criterion. In order to review the tax treatment of IP transactions, this paper explored various types of IP transactions and their related tax treatment in Australia, Egypt and India.

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<sup>116</sup> Jane G. Gravelle, *The Economic Effects of Taxing Capital Income*, (MIT Press, 1<sup>st</sup> ed, 1994), 62-68

<sup>117</sup> Ibid.

<sup>118</sup> For more details see, Gary Cywie, Bertrand and Agnes Mongin-Weiss, ‘Luxembourg: An Attractive New Tax Regime for Income Deriving from IP Rights’ (2009) *iam Magazine Building and Enforcing Intellectual property Value* 155-157. < <http://www.iam-magazine.com/issues/SupplementArticles.aspx?g=126c4e32-54a1-578b5966706490575e9&sp=allarticlesmagazine.com/issues/SupplementArticles.aspx?g=126c4e32-54a1-4578-b596-6706490575e9&sp=allarticles>> at 6 July 2009.

<sup>119</sup> For more details see for example, Andre Fourcans and Thierry Warin, ‘Can Tax Competition Lead to a Race to the Bottom in Europe? A Sceptical View’ (2006) Middlebury College, Economic Discussion Paper, 06-04.



IP business transactions often take one of the following forms: licensing and transfer, in addition to self-developed activities. The tax treatment of those transactions, particularly licensing and transfer, are often subject to ordinary tax provisions in the same way as other sources of income and related expenses. This reflects the concerns of each country to protect the tax base relating to IP business transactions. On the other hand, the tax treatment of the acquisition of IP, self-developed IP, and compulsory licensing of IP may vary from country to country, which reflects different tax policies towards encouragement of self-developed IP, hence dealing with the economic efficiency criterion.

The analysis of the tax treatment of IP under the Australian, Egyptian and Indian income tax legislation has revealed that a different approach is implemented by these countries, which reflects different income tax provisions and different tax policy attitudes. The Australian and Indian tax legislator is aware of the importance of IP and the necessity for specific tax treatment of IP. Therefore, Australian and Indian tax provisions reflect a tax policy which is more concerned with the efficiency of the tax system. This efficiency is tailored to deal with the high level of market failure and uncertainty associated with the development and use of IP.

Neutrality of the income tax system is not the optimal solution to deal with IP transactions. Moreover, racing to the bottom as a tax policy approach through lowering tax rates and broadening the tax base is not efficient in bringing foreign direct investment and to encourage investment in R&D. Accordingly, specific competition measures are required to compete with countries whose measures are related to encouraging Foreign Direct Investment (FDI) and domestic investment in R&D activities. Based on this argument, in order to maximise the current benefits of IP in developed countries and support the potential benefits of IP in developing countries, a tax system can contribute to these objectives through a number of measures which include:

1. Specific tax treatment of R&D through specific tax incentives, an important element for encouraging FDI and supporting domestic R&D activities;
2. A specific depreciation scheme, important for encouraging technology transfer and development of domestic IP;
3. More attention paid to providing favourable tax treatment to the proceeds of IP transfer, in particular for self-developed IP when it is transferred to spin off company;
4. Refraining from lowering the tax rate and broadening the tax base, as these steps would reflect an inefficient tax policy and create tax competition among neighbouring countries, and moreover may hinder future tax reform; and
5. Using specific legal forms such as venture capital, export processing zones or free zones to encourage specific industries which serve the development of IP rather than just commercial activities.