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## FOREWORD

The papers included in this edition of the Journal of the Australasian Tax Teachers Association (JATTA) are authored by members of the Australasian Tax Teachers Association (ATTA). In keeping with the traditions of the journal, submissions were invited following the 24th Annual Conference of the association. The conference, jointly hosted by Sydney Law School and the University of Sydney Business School, was held from Monday 16 January to Wednesday 18 January 2012 at the Sydney Law School's Camperdown campus. The theme of the conference was 'Tax change: Convergence or Divergence' and while only four of the nine papers in this edition of JATTA were presented at the conference, all of the papers reflect some degree of interest in that overall theme.

The papers in this edition reflect the diversity of research interests and styles pursued by tax teachers in Australia and New Zealand, including empirical research, traditional legal scholarship, policy analysis, and comparative tax law. Tax developments in Australia and New Zealand do not take place in isolation from the rest of the world, and the themes of both convergence and divergence can be seen in two papers that examine the tax treatment of charities, one that looks at changes to New Zealand's tax treaty policy, and another that undertakes a comparative analysis of the general anti-avoidance rules of Australia and South Africa. One paper considers issues surrounding the deductibility (or non-deductibility) of seismic strengthening costs in New Zealand, a topic that must invite consideration of the same issues by other countries where natural disasters have called into question existing building practices. Other papers focus on the evaluation (or non-evaluation) of the effectiveness of tax reforms, the audit experiences of small businesses, and of course, tax teaching — a topic that is of critical importance to all members of the association. As this year's guest editor, I learned a great deal from all of the papers.

The production of this volume would not eventuate without the efforts of many who give so willingly of their time. In particular, I thank again the anonymous peer reviewers, who generously gave their time to provide guidance and feedback on the papers in order to assist the authors to strengthen their arguments and present their thoughts in the best possible manner. Acting as a referee is an onerous task but one that is of great benefit to the authors, to the scholarly community, and to the wider tax community in which the Australasian Tax Teachers Association is a vibrant hub.

Finally, I thank the authors, for the hard work they put into their papers in order to contribute their knowledge and insights to our understanding of taxation and/or of tax teaching, and for so graciously considering the various editorial changes I suggested.

Rebecca Millar  
Sydney Law School, University of Sydney

27 November 2012

**CHARITIES' TAX PRIVILEGES IN NEW ZEALAND:  
A CRITICAL ANALYSIS**

JONATHAN BARRETT AND JOHN VEAL\*

**ABSTRACT**

This article critically analyses the tax privileges extended to charities in New Zealand. The concept of a charity is established, and the grounds for tax privileges are considered. Without gainsaying the social value that many charities deliver, the authors ask whether certain historical privileges are justified when measured against contemporary needs and circumstances. They conclude that far greater transparency is needed in the sector. Such openness would enable a fully informed debate about the types of charitable organisations the tax system encourages, and whether the tax privileges currently extended to them are justified.

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## I INTRODUCTION

The more than 25,000 charities registered in New Zealand enjoy various legal privileges,<sup>1</sup> which include the conferral of juristic personality,<sup>2</sup> trust law benefits,<sup>3</sup> and restricted exemptions from consumer protection,<sup>4</sup> employment,<sup>5</sup> and human rights legislation.<sup>6</sup> However, the most significant concessions granted to charities relate to tax, particularly income tax. Charities do not pay income tax on their exempt income,<sup>7</sup> and provided they do not receive any non-exempt income,<sup>8</sup> they are not required to file a tax return.<sup>9</sup> Income earned by charities from trading operations and subsequently distributed in New Zealand, is, in short, tax free. Consequently, charitable firms may be able to amass capital and build a business much more quickly than a for-profit competitor.<sup>10</sup> Furthermore, non-cash benefits provided by charities to their employees

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<sup>1</sup> Charities Commission, *Annual Report 10/11* (Charities Commission, 2011) 7 records that 22 657 registered charities had published annual returns as at 30 September 2011. Publishing an annual report is a normal condition of continued registration: See *Charities Act 2005* (NZ) (*'Charities Act'*) ss 41 and 32 but also s 43 (on reporting exemption). The Charities Commission website includes a counter of registered charities. On 9 August 2012, 25 279 charities were recorded. See Charities Commission, *Registered Charities* (2012) <<http://www.charities.govt.nz/>>. In terms of *Charities Amendment Act (No 2) 2012* (NZ) s 9, the functions of the Charities Commission were taken over by Department of Internal Affairs with effect from 1 July 2012.

<sup>2</sup> Charities generally enjoy the legal privilege of legal personality and, if charitable trusts, have the status of corporation sole: *Charitable Trusts Act 1957* (NZ) s 7.

<sup>3</sup> In contrast to the normal rule that trust capital must be distributed within 80 years (see *Perpetuities Act 1963* (NZ) s 6(1)), capital held by a charitable trust may be tied up in perpetuity: *Re Beckbessinger* (High Court, Christchurch, M 586/88, 28 September 1992, Tipping J).

<sup>4</sup> Following *E v Australian Red Cross Society* (1991) 99 ALR 601, it seems likely that charities will generally not be considered to be in trade for the purposes of the *Fair Trading Act 1986* (NZ). While charity shops will normally be covered by the *Consumer Guarantees Act 1993* (NZ), s 41(2) of that Act excludes transactions that have the 'principal purpose of benefiting a person'.

<sup>5</sup> Much charitable work is done by volunteers who are excluded from the definition of 'employee' under *Employment Relations Act 2000* (NZ) s 6(1)(c).

<sup>6</sup> *Human Rights Act 1993* (NZ) s 28 permits certain otherwise outlawed forms of discrimination in a religious context.

<sup>7</sup> *Income Tax Act 2007* (NZ) ss CW 41, CW 42, CW 43. Section CW 41 exempts the non-business income of charities. Section CW 42 exempts the business income of charities, but only to the extent that income is applied for charitable purposes within New Zealand. Section CW 43 exempts income derived by a deceased person's executor or administrator if the income is attributable to assets of the estate that have been left to a charity.

<sup>8</sup> Income derived by the charity that is not covered by the exemptions in *Income Tax Act 2007* ss CW 41 to CW 43. For example, the portion of the business income derived by a charity that relates to charitable purposes not limited to New Zealand.

<sup>9</sup> *Tax Administration Act 1994* (NZ) s 33. The Inland Revenue Department (IRD) may, however, request an annual tax return.

<sup>10</sup> This proposition appears to be received wisdom in New Zealand: see, for example, *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, 1967) ('Ross Report') 308–313; Policy Advice Division, *Tax and Charities: A General Discussion Document on Taxation Issues relating to Charities and Non-Profit Bodies* (IRD, 2001) 43. However, for a contrary view, see Henry Hansmann, 'The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit versus For-Profit Firms' (1987) 60 *National Tax Journal* 71, 71–82.

are currently exempt from fringe benefit tax ('FBT') unless the employee is involved in a business activity outside the charity's registered purposes.<sup>11</sup>

Charities also indirectly benefit from income tax concessions extended to donors.<sup>12</sup> Currently, subject to a minimum donation of NZ\$5, individuals may claim a tax credit of 33 $\frac{1}{3}$  per cent of their aggregate annual donations.<sup>13</sup> Furthermore, a payroll giving scheme enables employees' donations to be deducted directly from their remuneration, with immediate tax credit being granted.<sup>14</sup> Companies, excluding look-through companies,<sup>15</sup> may deduct the value of all cash gifts to charities, not exceeding the company's net income.<sup>16</sup>

The New Zealand charitable sector was reformed in 2005, with tax exemption becoming contingent on registration with the Charities Commission and production of an annual report.<sup>17</sup> However, the reforms were not intended to be radical.<sup>18</sup> In contrast, a 2001 discussion paper issued by IRD's Policy Advice Division made far reaching income tax recommendations that were mostly not taken up.<sup>19</sup> While the 2005 reforms may have contributed to transparency in the 'third sector',<sup>20</sup> and thereby reduced potential for abuse by rogue charities,<sup>21</sup> the amended deduction rules may have presented novel opportunities for income tax avoidance and evasion.<sup>22</sup>

This article considers the principal policy issues that arise from charities' and donors' tax privileges. First, an overview of charities is provided. This section sketches the

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<sup>11</sup> *Income Tax Act 2007* s CX 25.

<sup>12</sup> *Income Tax Act 2007* s LD 3. Donations to qualifying donee organisations also qualify for tax concessions. See IRD, *Charitable Organisations and Donee Organisations (IR 255)* (IRD, 2011) 27 for an outline of donee organisation qualification.

<sup>13</sup> *Income Tax Act 2007* ss LD 1–LD 3. The total gifts that qualify for the tax credit may not exceed the individual's taxable income: *Tax Administration Act 1994* (NZ) s 41A(3).

<sup>14</sup> *Income Tax Act 2007* ss LD 4–LD 8. This scheme came into effect in January 2010. As at 12 March 2012, payroll giving was offered by 1 300 employers and over 100 000 employees had access to the scheme. See IRD, *New Website Offers Payroll Giving Help for Employers* (2012) <<http://taxpolicy.ird.govt.nz/news/2012-03-12-payroll-giving-website-launched>>. During the 12 months ended 31 January 2012, total donations through payroll giving totalled over NZ\$5 million. See *Payroll Giving Statistics to Date* <<http://www.ird.govt.nz/news-updates/like-to-know-payroll-giving-long-des.html>>.

<sup>15</sup> *Income Tax Act 2007* s YA 1 definition of 'company' para (abb). Before 1 April 2008, deduction for corporate charitable donations was not available to defined 'close companies' unless their shares were publicly listed.

<sup>16</sup> *Income Tax Act 2007* s DB 41.

<sup>17</sup> See above n 1. Registration is voluntary but an unregistered charity may not describe itself as a 'registered charitable entity' and does not qualify for tax exemption. See Charities Commission, *Purpose of the Charities Register* <<http://www.charities.govt.nz/the-register/purpose/>>.

<sup>18</sup> For example, the Explanatory Note, Charities Bill 2005 (1–108) indicated that it was not the intention of Parliament to change the definition of 'charitable purpose'.

<sup>19</sup> Policy Advice Division, above n 10. Ross Report, above n 10, 308–313 appears to have been influential here.

<sup>20</sup> The term 'third sector' – government and business being the other sectors – was coined by the Commission on Private Philanthropy and Public Needs ('CPPPN'), *Giving in America, Toward a Stronger Voluntary Sector: Report of the Commission on Private Philanthropy and Public Needs* (CPPPN, 1975) (also known as the 'Filer Commission') 1, 11.

<sup>21</sup> See Catherine Harris, 'Database to Reveal the Real Charities' *The Dominion Post* (Wellington), 29 December 2011, 4.

<sup>22</sup> See below n 67.

origins of current law and the contemporary position of charities in New Zealand. Second, the tax privileges New Zealand charities enjoy are outlined. Third, the principal arguments for and against tax privileges are discussed in the specific New Zealand context. Finally, tentative recommendations are made and conclusions drawn.

## II OVERVIEW OF CHARITIES

The legal concept of a charity in common law countries is derived from the Preamble to the *Charitable Uses Act 1601*.<sup>23</sup> In *Commissioner of Income Tax v Pemsel*,<sup>24</sup> Lord Macnaghten, following, but reducing the Preamble list to principles, held that a charity must be for the public benefit and have the purpose of relieving poverty,<sup>25</sup> advancing education, advancing religion, or benefiting the community.<sup>26</sup> Charitable purposes not contemplated in Elizabethan times could be accommodated, if consistent with the Preamble's 'spirit and intendment'. 'The law does not recognise all objects of public utility as charitable', for example political advocacy is, in theory, excluded.<sup>27</sup> Not all charitable purposes are equal. For example, their aims being presumed to be self-evident, charities for the relief of poverty, advancement of religion or education have traditionally not been required to specifically demonstrate public benefit.<sup>28</sup> However, the public benefit of private education has recently come under scrutiny in the United Kingdom.<sup>29</sup> Charities may conduct a business provided it is 'not carried on for the private pecuniary profit of any individual'.<sup>30</sup> Indeed, given the scale of religiously affiliated businesses, such as the Seventh Day Adventist Church's Sanitarium operations,

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<sup>23</sup> 43 Eliz I c 4, also known as the *Statute of Charitable Uses* or the *Statute of Elizabeth*. Roman law, Judaeo-Christian theology, and the common law were influential, but, critically, the Tudor Reformation had disrupted the Church's traditional charitable function. Significantly, the *Charitable Uses Act* was companion legislation to the *Poor Law Act 1601* 43 Eliz I c 2. According to John Seymour, 'Parens Patriae and Wardship Powers: Their Nature and Origins' (1994) 14(2) *Oxford Journal of Legal Studies* 159, 159-188 the origins of State charity lie with the sovereign's obligations as *parens patriae* (father of the country).

<sup>24</sup> *Commissioner of Income Tax v Pemsel* [1891] AC 531.

<sup>25</sup> LexisNexis, *The Laws of New Zealand* (at 17 April 2012) 'Charities' [14] states: 'The word "relief" implies that the persons in question have a need attributable to their condition as aged, impotent, or poor persons which requires alleviating, and which those persons would find difficulty in alleviating themselves from their own resources.' The words 'relief' and 'benefit' are not synonymous: *Joseph Rowntree Memorial Trust Housing Association Ltd v Attorney-General* [1983] 1 All ER 288. Poverty is likely to be taken as relative to other members of the community, rather than absolute: see *Ballarat Trustees Executors and Agency Company Ltd v Attorney-General* (1950) 80 CLR 350.

<sup>26</sup> Reducing the purposes still further, Jan James and Peter Felstead, *Charitable Trusts and Entities* (Auckland District Law Society, 2002) 3 suggest that, to fall within the ambit of *Pemsel*, the pursuit of the purpose must benefit the public or an appreciable or sufficiently important section of the public ('public benefit test'); and the purpose must be charitable, being a purpose that falls within the 'spirit and intendment' of the Preamble.

<sup>27</sup> *The Laws of New Zealand*, above n 25, [3]. However, many charities do, in practice, engage in forms of advocacy that aim at changing attitudes, policy, and ultimately law.

<sup>28</sup> See, for example, *In re Hetherington* [1990] Ch 1. Giving alms to the poor is the original meaning of charity and still coincides with the everyday understanding of the term.

<sup>29</sup> See *The Independent Schools Council v The Charity Commission for England and Wales* [2011] UKUT 421 (14 October 2011). For an analysis of this decision from a New Zealand perspective, see Helen Dervan, 'Independent and Schools and Charitable Status' (2012) *New Zealand Law Journal* 51, 51-54.

<sup>30</sup> Charities Act s 13(3).



Max Wallace has described charities' participation in trade in Australasia as 'the Purple Economy'.<sup>31</sup>

Historical contingencies, including British settlement and a sparse population, have greatly shaped the charitable sector in New Zealand. Statutory definitions of 'charity' tend to be circular, and lead back to the common law,<sup>32</sup> and, prompted by necessity, 'from an early stage the prevailing policy was to encourage charities, usually church-based community groups, to fill the gap and establish the health and social care facilities for the poor, ill or otherwise disadvantaged that government could not afford to provide'.<sup>33</sup> Since State-provided welfare was mostly absent from early New Zealand, 'self-help and family support were more important than government aid and formal charity in meeting welfare needs'.<sup>34</sup> The country's third sector remains characterised by a 'partnership ethos between government and community'.<sup>35</sup> Government in contemporary New Zealand has command over sufficient resources to deliver many of the services that charities currently perform — indeed, the greatest part of charities' income is derived directly from government<sup>36</sup> — and yet, it seems, the State prefers to pay and subsidise charities. This approach is consistent with neoliberal doctrines whereby government purchases services from various and competing agencies,<sup>37</sup> including traditional charities, rather than providing them directly.<sup>38</sup>

### III TAX PRIVILEGES

In this section, the history of tax concessions and current privileges in New Zealand are outlined.

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<sup>31</sup> Max Wallace, *The Purple Economy: Supernatural Charities, Tax and the State* (Australian National Secular Society, 2007).

<sup>32</sup> See, for example, Charities Act s 5. Compare this with Australia (Royal National Agricultural and Industrial Association v Chester [1974] 48 ALJR 304) and Canada (Vancouver Society of Immigrant and Visible Minority Women v MNR (1999) 169 DLR (4th) 34 (SCC)).

<sup>33</sup> Kerry O'Halloran, *Charity Law and Social Inclusion: An International Study* (Routledge, 2007) 280.

<sup>34</sup> Gino Dal Pont, *Charity Law in Australia and New Zealand* (Oxford University Press, 2000) 78. It was not until the *Social Security Act 1938* (NZ) that 'income maintenance in the time of need' became 'a right of citizenship'. (Ibid).

<sup>35</sup> O'Halloran, above n 33, 281.

<sup>36</sup> Charities' income of approximately NZ\$15 billion in 2011 consisted of: government grants (NZ\$4.997 billion); donations (NZ\$1.040 billion); income from service provision (NZ\$5.667 billion); and other income, including investments (NZ\$3.214 billion). See Charities Commission, above n 1, 7.

<sup>37</sup> The Royal Plunkett Society, a prime example of a State-partner charity, had provided a child illness helpline for many years. In a competitive tender, it lost the right to provide this service. See 'Plunkett Loses Government Helpline Contract' *The New Zealand Herald* (online), 8 April 2006 <[http://www.nzherald.co.nz/nz/news/article.cfm?c\\_id=1&objectid=10376607](http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10376607)>.

<sup>38</sup> See, generally Margaret Tennant, Jackie Sanders, Michael O'Brien, and Charlotte Castle, *Defining the Nonprofit Sector: New Zealand* (Working Paper No 45, Johns Hopkins Comparative Nonprofit Sector Project, 2006).

## **A Income Tax**

### **1 Charities' Exemptions**

John Avery Jones traces English charities' tax privileges directly to land tax exemptions promulgated in 1671 and 1688, and indirectly to sixteenth century subsidies.<sup>39</sup> The proto-income tax introduced by William Pitt the Younger in 1799 exempted the income of any 'corporation, fraternity or society of persons established for charitable purposes only'.<sup>40</sup> The broad charitable exemption from taxes has persisted in British Commonwealth countries.<sup>41</sup> In New Zealand, the first land and income tax, introduced in 1891, exempted all income derived or received by, among others, 'all public bodies and societies not carrying on any business'.<sup>42</sup> The following year, an exemption was introduced in respect of 'mortgages held, and all income received or derived, by or on behalf of any public charitable institution ... not for any gain or profit'.<sup>43</sup> This formulation of exemption based on the dual criteria of charitable status and a not-for-profit motive was continued in subsequent legislation.<sup>44</sup> While the expression of the exemption became more prolix,<sup>45</sup> the exemption formulation has remained essentially the same. Following the *Pemsel* formulation,<sup>46</sup> the current income tax legislation defines 'charitable purpose' as including 'every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community'.<sup>47</sup>

### **2 Taxpayer Concessions**

Historically, income tax concessions were not available in respect of taxpayers' charitable donations.<sup>48</sup> In 1962, an innovative provision introduced a deduction (by way of special exemption) from the assessable income of individuals making donations to charities: the deduction was limited to £25. When income tax legislation was consolidated in 1976, the maximum deduction was NZ\$200.<sup>49</sup> This deduction was replaced in 1978 by a rebate for charitable deductions by individuals, calculated at the rate of 31 per cent of qualifying donations, but limited to NZ\$200.<sup>50</sup> In 1990, the rate at which the rebate was calculated became the current rate of 33 $\frac{1}{3}$  per cent but subject to a

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<sup>39</sup> John F Avery Jones, 'The Special Commissioners from Trafalgar to Waterloo' in John Tiley (ed), *Studies in the History of Tax Law* (Hart Publishing, 2007) 3, 14.

<sup>40</sup> *Income Tax Act 1799*, 39 Geo III c13, s 5, cited by Fiona Martin, 'The History of the Taxation of Charities: How the Common Law Development of a Legal Definition of 'Charity' Has Affected the Taxation of Charities' in John Tiley (ed), *Studies in the History of Tax Law 4* (Hart Publishing Ltd, 2010) 297, 309.

<sup>41</sup> Martin, *ibid*, notes that, once income tax was reintroduced in 1842, charitable tax privileges were retained.

<sup>42</sup> See *Land and Income Assessment Act 1891* (NZ) s 16(2).

<sup>43</sup> See *Land and Income Assessment Act Amendment Act 1892* (NZ) s 3.

<sup>44</sup> See *Land and Income Assessment Act 1900* (NZ) s 16(1); *Land and Income Assessment Act 1908* (NZ) s 14(1); *Land and Income Tax Act 1954* (NZ) s 86(1).

<sup>45</sup> See *Income Tax Act 1976* (NZ) s 61.

<sup>46</sup> See *Molloy v Commissioner of Inland Revenue* [1981] 1 NZLR 688.

<sup>47</sup> *Income Tax Act 2007* s YA 1 definition 'charitable purpose'.

<sup>48</sup> *Land and Income Tax Act 1954* (NZ) s 84B came into effect on 1 April 1962.

<sup>49</sup> *Income Tax Act 1976* (NZ) s 58.

<sup>50</sup> *Income Tax Act 1976* (NZ) s 56A.

maximum of NZ\$500.<sup>51</sup> The maximum rebate increased to NZ\$630 in 2002.<sup>52</sup> With effect from 1 April 2008, and the introduction of the current *Income Tax Act 2007*, the term 'rebate' was replaced by 'tax credit', and the then applicable maximum of NZ\$630 was removed. To reiterate, the current amount of the personal tax credit is limited only to the extent that it may not exceed an individual's taxable income.<sup>53</sup> In the 2010 tax year, 376,500 claims for donations were made and IRD rebated a total of NZ\$195 million.<sup>54</sup>

## **B Other Taxes**

### **1 Taxes on Capital Transfers**

An exemption from estate duty for charitable bequests was instituted soon after the introduction of the duty in 1881.<sup>55</sup> Under the estate and gift duties system, charitable donations and legacies continued to attract favourable tax treatment.<sup>56</sup> New Zealand no longer levies any form of tax on capital transfers.<sup>57</sup>

### **2 Local Property Rates**

Rates levied on real property are the principal source of local authority revenue in New Zealand.<sup>58</sup> Local authorities have wide discretion in the mix of the rating instruments they can employ,<sup>59</sup> but certain exclusions from the ratings base are peremptory and not open to local variation or preference. In particular, places of worship, which commonly have significant land and capital values,<sup>60</sup> and various types of charitable institution, are exempt from local authority rates.<sup>61</sup>

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<sup>51</sup> There was some variation in the rate and maximum allowance between 1978 and 1990.

<sup>52</sup> Policy Advice Division (above n 10, 10) recommended that the amount of the maximum deduction should increase with the rate of inflation.

<sup>53</sup> See above nn 7–14 for the relevant statutory provisions, and above nn 15 and 16 on companies' deductions.

<sup>54</sup> IRD, *Donation Rebates, 2001 to 2010* (2011) <<http://www.ird.govt.nz/aboutir/external-stats/revenue-refunds/donations-rebates/revenue-refunds-donation-rebates.html>>.

<sup>55</sup> *Charitable Gifts Duties Exemption Act 1883* (NZ) s 3 exempted charitable devises and bequests from the *Deceased Persons' Estates Duties Act 1881* (NZ) 'or any other Act of a like character'.

<sup>56</sup> See *Estate and Gift Duties Act 1968* (NZ) ss 5(c), 73(1).

<sup>57</sup> Estate duty was abolished in 1992 and gift duty in 2010.

<sup>58</sup> Graham Bush, 'Local Government' in Raymond Miller (ed), *New Zealand Government and Politics* (Oxford University Press, 2003) 161, 164 reports that in 2001 an average of 57 per cent of local authority revenue was contributed by rates (excluding user charges). K A Palmer, *Local Government Law in New Zealand*, (2nd ed, Law Book Co, 1993) 362 defines rating as 'a levy on land holdings, assessed against the legal occupier, for the purpose of raising revenue for one or more local authorities'.

<sup>59</sup> See *Local Government Rating Act 2002* (NZ) ss 13–19.

<sup>60</sup> Figures are not readily available in New Zealand on the benefits that excluded property brings to its owners. However, a 2000 investigation indicated that, if the exempt property of religious organisations were included in the rating base, Melbourne's rates could be reduced by 10 per cent. See Sally Blundell, 'The God Dividend' *New Zealand Listener* (New Zealand), 2 February 2008, 26, 28.

<sup>61</sup> *Local Government Rating Act* s 8 and sch 1. See Michael Gousmett, 'The Fiscal Privileges of Charities' [2012] *New Zealand Law Journal* 55, 55–59 for a critical analysis of charities' exemption from the ratings base.

### 3 Goods and Services Tax

In general,<sup>62</sup> charities must register for goods and services tax ('GST'), and account for GST, if they make taxable supplies in excess of NZ\$60,000 per annum. However, various GST concessions apply to non-profit bodies,<sup>63</sup> including charities. A non-profit body may treat each of its branches or divisions as separate entities for GST purposes, with the result that each branch or division is only required to register for GST if its annual taxable supplies exceed NZ\$60,000.<sup>64</sup> Non-profit bodies are not required to account for GST on unconditional gifts they receive.<sup>65</sup> Furthermore, sales of donated goods and services by a non-profit body are exempt from GST.<sup>66</sup> These concessions may facilitate avoidance.<sup>67</sup>

## IV SHOULD CHARITIES ENJOY PREFERENTIAL TAX TREATMENT?

Having outlined charitable tax concessions in New Zealand, in this section, major arguments for and against preferential tax treatment of charities are considered.<sup>68</sup>

### A General Arguments

#### 1 Role as a Quasi-Government Agency

The third sector seeks to bridge the gap between the public services citizens in general expect to be able to access and those the State and the market actually provide. Consequently, numerous charities deliver public services that the State might otherwise provide. This is not an ideological judgment about the extent of government reach; New Zealand is treaty-bound to satisfy its citizens' economic, social and cultural rights.<sup>69</sup> In terms of subsidy theory, granting tax-free status to charities, which act as quasi-government agencies, is justified as it constitutes a means of indirect State funding of

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<sup>62</sup> See Graeme S Cooper and Richard J Vann, 'Implementing the Goods and Services Tax' (1999) 21 *Sydney Law Review* 337, 354 for a discussion of the principal problems that arise from charities and GST.

<sup>63</sup> There are some 97,000 not-for-profit organisations in New Zealand. See Statistics New Zealand, *Non-Profit Institutions Satellite Account: 2004* <[http://www.stats.govt.nz/browse\\_for\\_stats/industry\\_sectors/non-profit-institutions-satellite-account-2004.aspx](http://www.stats.govt.nz/browse_for_stats/industry_sectors/non-profit-institutions-satellite-account-2004.aspx)>.

<sup>64</sup> *Goods and Services Tax Act 1985* (NZ) ('GST Act') s 51(5).

<sup>65</sup> See the definitions of 'consideration' and 'unconditional gift' in *GST Act* s 2(1).

<sup>66</sup> *GST Act* s 14(1)(b).

<sup>67</sup> IRD has identified the following avoidance scheme: fundraising is done on behalf of a charity. Donations are passed to an intermediary closely related to the charity, who is expected to 'donate' these funds to the charity. The charity will not account for GST on the fundraising. Furthermore, the intermediary will claim a donations tax credit, which may be donated to the charity. See IRD, *Revenue Alert RA 11/01* (2011) <<http://www.ird.govt.nz/technical-tax/revenue-alerts/revenue-alert-ra1101.html>>. See also Michael Gousmett, 'Charities and Business Activities' (2009) *New Zealand Law Journal* 57, 57-60 on charitable abuse of the 'corporate veil' and tax avoidance.

<sup>68</sup> For a comprehensive literature review of taxation of charities, see Not-for-Profit Project, *Taxing Not-For-Profits: A Literature Review* (Melbourne Law School, 2011).

<sup>69</sup> See, in particular, the *International Covenant on Economic, Social and Cultural Rights ICESCR*, GA Res 2200A (XXI), 21 UN GAOR Supp (No 16), at 49, UN Doc A/6316 (1966), 993 UNTS 3.

essential services.<sup>70</sup> This is a particularly strong argument in New Zealand, where government has traditionally refrained from providing certain popularly expected public services.<sup>71</sup> Furthermore, since the neoliberal ascendancy in the mid-1980s, governments have relied on charities as they retreat from the role of the 'welfare state as the reliable provider of benefit'.<sup>72</sup> Charities are, then, increasingly contracted to give effect to governments' mandates. However, there are important distinctions between direct government provision of welfare and government supported welfare through charitable agencies. First, the greater the size of the third sector providing the welfare services the State would otherwise provide, the less citizens have actionable rights claims.<sup>73</sup> Second, unlike government agencies, charities are not subject to direct Ministerial oversight, judicial review or investigation by important watchdog institutions of modern governance, such as an Ombudsman or Auditor-General.<sup>74</sup>

Beyond specific contractual mandate, charities and other non-profit organisations may help government to further the broad objective of social inclusion. Increasing support to disadvantaged members of society, for example, may foster a more caring and cohesive political community.<sup>75</sup> A flourishing third sector may contribute to a fair society: all citizens may gain psychic benefits from living in a society in which everyone enjoys a basic minimum standard of living and care. In a pluralist society, it may be politically problematic for government to focus on the diverse social needs of different minority groups.<sup>76</sup> Charitable provision of public utilities helps 'to acknowledge the diversity of social need, broadens the range of utilities available and thereby enhances the capacity of a society to act in a more inclusive manner'.<sup>77</sup> Generally, the public interest is likely to be served by facilitating charities' altruistic activities.<sup>78</sup>

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<sup>70</sup> For an analysis of subsidy theory, see John Simon, Harvey Dale and Lisa Chisholm, 'The Federal Tax Treatment of Charitable Organizations' in Walter W Powell and Richard Steinberg (eds), *The Nonprofit Sector: A Research Handbook* (2nd ed, Yale University Press, 2006) 267, 274–275.

<sup>71</sup> It is noteworthy that New Zealand government neither provides nor significantly funds certain services that citizens need and expect, such as rescue helicopters. See 'The Air Ambulance Rescue Trusts', *Independent Financial Review* (New Zealand), 10 September 2009, 7 for an analysis of the sources of funding of the country's air ambulance trusts.

<sup>72</sup> Dal Pont, above n 34, 3. During the 2011 financial year, charities received NZ\$5.5 billion for service provision and NZ\$4.8 billion in government grants. See Charities Commission, *A Snapshot of New Zealand's Charitable Sector: A Profile of Registered Charities as at 28 February 2011* (2011) <<http://www.charities.govt.nz/assets/docs/key-statistics/2011/sector.pdf>>.

<sup>73</sup> Furthermore, as Colin Crouch, *Post-Democracy* (Polity Press, 2004) 19 observes, the less the State directly provides for the needs of ordinary people, the more apathetic those people will become about democracy.

<sup>74</sup> As noted, with effect from 1 July 2012, a Board was established to take over the functions of the Charities Commission. The members of the Board are appointed by the Minister of Internal Affairs, and many functions will be delegated to the Department of Internal Affairs: see *Charities Act* s 8.

<sup>75</sup> Policy Advice Division, *Tax Incentives for Giving to Charities and Other Non-Profit Organisations: A Government Discussion Document* (IRD, 2006) 3.

<sup>76</sup> Dal Pont, above n 34, 3.

<sup>77</sup> O'Halloran, above n 33, 36.

<sup>78</sup> *Ibid*, 20.

When directly implementing government's social requirements, charities are contractually answerable to their principal.<sup>79</sup> However, in relation to more nebulous outcomes, such as contributing to a fairer society, charities have no statutorily-imposed focus of accountability;<sup>80</sup> indeed, they 'face multiple and competing accountability demands'.<sup>81</sup> Since 'the primary source of accountability in nonprofit organizations is in the external environment',<sup>82</sup> unlike directors of companies, whose duties to the company are, in effect, owed to the body of shareholders,<sup>83</sup> managers of charities may lack the internal performance pressures that can be expected in the private sector.<sup>84</sup> One consequence of this potential independence from stakeholder oversight is that charities may amass wealth, rather than distribute it.<sup>85</sup> Whereas accumulating capital to, say, build a night shelter for the homeless is unquestionably legitimate, it is a moot point whether a cycle of wealth accumulation and capital investment for the benefit of a particular religious denomination warrants tax privilege.<sup>86</sup>

Since all charities qualify for tax concessions, not only those providing services that would otherwise be government's direct responsibility, such tax privilege is 'an imprecise policy instrument and an inefficient way of providing analysis'.<sup>87</sup> Some social services may be more effectively provided by the third sector, but surely not all charities provide services that might otherwise be provided by government? This question is particularly relevant to religious proselytising, which obviously would not be provided by a secular State. The role of religion in society lies beyond the scope of this article, nevertheless it is pertinent to note the observation of Wendy Cadge and Robert Wuthnow that religion has proved to be an ally of the progressive governments 'in such wide-ranging social causes as education, healthcare reform, overcoming racial discrimination, and protecting the environment'.<sup>88</sup>

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<sup>79</sup> See Shirley Sagawa and Eli Segal, *Common Interest, Common Good: Creating Value through Business and Social Sector Partnerships* (Harvard Business School Press, 1999) 156, on social enterprises that commonly seek independence from the grants of both government and large foundations so as not be compromised by the principal's mandate.

<sup>80</sup> According to the Charities Commission, charities should have a strong board and be accountable and transparent, but this is a matter of the Commission's 'vision', rather than a statutory requirement. See Charities Commission, *The Qualities of an Effective Charity* (2009) <<http://www.charities.govt.nz/assets/docs/information-sheets/qualities-of-an-effective-charity.pdf>>.

<sup>81</sup> Alnoor Ebrahim, 'The Many Faces of Nonprofit Accountability' (Working Paper 10-1069, Harvard Business School, 2010) 1, 26.

<sup>82</sup> Kevin P Kearns, 'The Strategic Management of Accountability in Nonprofit Organizations: An Analytical Framework' (1994) 54(2) *Public Administration Review* 185, 191.

<sup>83</sup> See, for example, Peter Watts, *Directors' Power and Duties* (LexisNexis, 2009) 142.

<sup>84</sup> The social enterprise movement seeks to incorporate the disciplines of the corporation into charitable organisations. See, for example, Nic Frances, *The End of Charity: Time for Social Enterprise* (Allen & Unwin, 2008).

<sup>85</sup> In the United States, in terms of 26 USC § 4942, private foundations are subject to minimum distribution rules.

<sup>86</sup> See Wendy Cadge and Robert Wuthnow, 'Religion and the Nonprofit Sector' in Walter W Powell and Richard Steinberg (eds), *The Nonprofit Sector: A Research Handbook* (2nd ed, Yale University Press, 2006) 485, 485-505 for a discussion of the merits of religious organisations qualifying for charitable privileges.

<sup>87</sup> Dal Pont, above n 34, 450.

<sup>88</sup> Cadge and Wuthnow, above n 86, 500.

## 2 *Advocacy for the Disempowered*

Kerry O'Halloran notes that:<sup>89</sup>

the trust and specialist knowledge that charities build up in the processes of mediating between giver and recipient places them in a crucially important strategic position between State and citizens, as broker on behalf of the socially disadvantaged and vests them with the responsibility to work with both to further social inclusion.

Having the 'stamp of virtue', charities can mollify the effects of a market economy and link back to traditions of caring.<sup>90</sup> They 'are then often the only acceptable agency positioned to advocate on behalf of and empower those who would otherwise be left to become alienated'.<sup>91</sup> This socially invaluable role is not, however, performed by all registered charities; perhaps by relatively few of the more than 25,000 charities registered in New Zealand. Furthermore, without a clear statutory mandate and status,<sup>92</sup> advocacy for the disempowered can have undesirable consequences for charitable organisations.<sup>93</sup> Rather than subsidising such a vague function through tax concessions, a dedicated office, perhaps a Commissioner for the Disempowered analogous to the Commissioner for the Environment, might be established.

## 3 *Problem of Income Measurement*

Charities' income may be difficult to measure because donations are generally excluded from the tax system,<sup>94</sup> but, whereas measurement of charities' taxable income may be problematic, it is not technically impossible.<sup>95</sup> Furthermore, technical barriers in assessing income do not justify other concessions, such as exemption from local property rates.

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<sup>89</sup> O'Halloran, above n 33, 12.

<sup>90</sup> See, for example, Social Policy and Parliamentary Unit, *The Growing Divide: A State of the Nation Report from the Salvation Army 2012* (Salvation Army New Zealand, Fiji and Tonga Territory, 2012).

<sup>91</sup> O'Halloran, above n 33, 35.

<sup>92</sup> Cf the role of 'critic and conscience of society' established for universities under the *Education Act 1989* (NZ) s 162(4)(a)(v).

<sup>93</sup> On 19 September 1979, CORSO lost its tax exempt status and an annual NZ\$40,000 government grant after it released a film criticising the government and drawing attention to New Zealand's role in labour exploitation in Hong Kong, and poverty amongst Māori. See David Sutton, Caroline Cordery and Rachel Baskerville, *Paying the Price of the Failure to Retain Legitimacy in a National Charity: the CORSO Story* (Working Paper No 47, Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2007).

<sup>94</sup> See Boris I Bittker and George K Rahdert, 'The Exemption of Non-Profit Organizations from Federal Income Tax' (1976) 85 *Yale Law Journal* 299, 305. Based on Charities Commission, above n 1, approximately NZ\$9 billion of New Zealand charities' income comes from eminently measurable government grants and income from service provision.

<sup>95</sup> Miranda Perry Fleischer, 'Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice' (Illinois Law & Economic Research Papers Series Research Paper No LE 09-006, University of Illinois College of Law, 2009) 10 <papers.ssrn.com/sol3/papers.cfm?abstract\_id=1348772>.

#### 4 *Compensation for Inability to Raise Capital*

Henry Hansmann observes that 'in raising capital, nonprofits are limited to three sources: debt, donation, and retained earnings. These three sources may, in many cases, prove inadequate to provide a nonprofit with all the capital it needs'.<sup>96</sup> Consequently, while noting that 'an exemption from income taxation is a crude mechanism for subsidizing capital formation in the nonprofit sector',<sup>97</sup> Hansmann argues that 'the need for capital subsidies provides some justification for exempting nonprofits from corporate income taxation in those industries in which, owing to contract failure, nonprofits have important efficiency advantages over for-profit firms'.<sup>98</sup> Certain charities, notably churches, may already possess substantial real property holdings, which themselves attract generous rating concessions. Government might consider charities' limited access to capital markets a matter worthy of intervention, particularly where the nonprofit sector is more efficient at delivering services than for-profit firms, but it needs to be asked whether the blunt instrument of tax privilege is an appropriate means of solving the problem.

#### 5 *Responsiveness and Effectiveness*

Charities — and their donors — may respond more quickly to developing social needs than government.<sup>99</sup> This argument is particularly plausible with regard to identifying 'the emerging needs of isolated groups in society', notably newly arrived minorities.<sup>100</sup> Consistent with public choice theory,<sup>101</sup> the donations people choose to make may effectively indicate the extra public goods and services needed in society. Furthermore, because charities typically use donated goods and volunteer labour they may represent a financially more efficient way of providing social assistance than government programmes.<sup>102</sup> Conversely, unlike government agencies that are funded by compulsory taxes, to remain viable in a highly competitive donations marketplace, charities are increasingly reliant on professional managers, expensive marketing campaigns and ubiquitous paid 'chuggers'.<sup>103</sup> Without access to compulsory contributions, they may be subject to a donations 'feast or famine'. In a recession, when crises have 'vacuumed up' donors' disposable dollars, or when 'donor fatigue' has set in, charities become

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<sup>96</sup> Henry Hansmann, 'The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation' (1981) 91 *Yale Law Journal* 54, 72. Conversely, charities are not subject to the onerous capital subscription rules that apply to for-profit organisations when raising funds from the public: see generally the *Securities Act 1978* (NZ).

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

<sup>98</sup> *Ibid.*, 75. For a critique of Hansmann's capital formation theory, see Ira Ellman, 'Another Theory of Nonprofit Corporations' (1982) 80 *Michigan Law Review* 999, 999–1018.

<sup>99</sup> Policy Advice Division, above n 75, 3.

<sup>100</sup> Dal Pont, above n 34, 3.

<sup>101</sup> John Meadowcroft, *Major Conservative and Libertarian Thinkers: James M Buchanan* (Continuum International Publishing Group, 2011) 1, identifies public choice as the application of 'economic theory and analysis to public decisions in the political realm'.

<sup>102</sup> Policy Advice Division, above n 75, 3.

<sup>103</sup> The social mischief caused by third party fund raisers is considered sufficiently serious for specific legislation to have been introduced. See *Fair Trading (Soliciting on Behalf of Charities) Act 2012* (NZ).



vulnerable and their effectiveness can be challenged. Conversely, in the face of a catastrophe, charities may be simply incapable of handling inflows of donations.<sup>104</sup> There is no way of ensuring that the public donates to the 'right' charity in the time of a crisis. Even under normal conditions, the emotional aspect of charity is likely to ensure that donations are not made in a way that rationally ensures the long-term public good. For example, many people may prefer to give a portion of their scarce resources to a charity that researches an obscure childhood disease, rather than one that helps prevent prisoner recidivism.

### ***B Donors' Tax Privileges***

The discussion so far could be reduced to the binary oppositions: charities are good/bad and therefore should/should not receive tax privileges. These arguments largely apply to concessions directly extended to charities but also to donors' tax deductions or credits. Further specific considerations apply to donor concessions.<sup>105</sup>

#### *1 Incentives*

*The Laws of New Zealand* sums up the two basic considerations that inform taxpayer concessions for charitable donations in the following terms:<sup>106</sup>

The object of the Legislature in relieving charitable gifts from [tax] is to encourage such gifts. Taxation is remitted from such gifts because the public receives a benefit from that remittance, as the burden of maintaining the objects of the gift and the burden upon finances are lessened by the remittance. On the other hand, an exemption to a taxing statute adds to the burdens of the public.

In short, those who can afford to donate should be encouraged to do so,<sup>107</sup> but all taxpayers share the burden of a donor's generosity.<sup>108</sup> Assuming that charities provide the types of public services taxpayers actually want and use — although, that is far from certain — spreading costs across all taxpayers prevents free riding.<sup>109</sup> However, in practice, there is no proven connection between the services a charitable organisation chooses to provide and potentially free riding taxpayers.

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<sup>104</sup> See Robert A Katz, 'A Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief' (2003) 35 *Indiana Law Review* 251, 251-333 on the inability of American charities to deal with the massive inflow of donations following the 11 September 2001 terrorist attacks.

<sup>105</sup> Strictly speaking, in the New Zealand context, these questions should be distinguished between whether donations to charities by (a) companies (especially closely held companies) should qualify for a deduction; or (b) individuals should qualify for a tax credit. While recognising that companies do not directly experience utility or disutility, the two queries are conflated for convenience.

<sup>106</sup> *The Laws of New Zealand*, above n 25, [287].

<sup>107</sup> Dal Pont, above n 34, 448. For a full discussion of the potential role of theorising charitable tax privileges, see Fleischer, above n 95, 19-47.

<sup>108</sup> It is typically argued that it is unfair that taxpayers with the highest marginal tax rates should benefit the most: see, for example, Dal Pont, above n 34, 450. However, this argument is not valid in New Zealand because individuals qualify for a tax credit, rather than a tax deduction. Consequently, all taxpayers obtain the same amount of tax credit for the same amount donated.

<sup>109</sup> Boris I Bittker, 'Charitable Contributions: Tax Deductions or Matching Grants' (1978) 28 *Tax Law Review* 37, 37-63.

## 2 *Donation as Consumption*

The dominant Haig-Simons model of income includes accretions in wealth and consumption between points in time.<sup>110</sup> On this logic, if a donation does not constitute consumption, it is not income and should, therefore, be excluded or deductible from income tax. It may be argued that a donor forgoes the economic power to consume the value of a donation, and therefore the donation should not be taxed as income.<sup>111</sup> Furthermore, a donor, such as the philanthropist who endows an art gallery, may be said to share with others any benefit she receives from her donation.<sup>112</sup> However, as Miranda Fleischer observes, the more common view is that an individual's charitable donations do indeed constitute consumption and should, therefore, be taxable under the Haig-Simons model.<sup>113</sup> According to James Andreoni, 'warm glow' or 'impure altruism' theory indicates that '[w]hen people make donations to privately provided public goods, they may not only gain utility from increasing its total supply, but they may also gain utility from the act of giving'.<sup>114</sup> Not only may donors gain utility from giving, they may also enjoy the further psychic benefits of community esteem, and even recognisable rewards, such as degrees conferred *honoris causa* or public honours.

## 3 *Administrative Efficiency*

Donor concessions effectively divert revenue, which would otherwise go to the treasury, directly from taxpayers to charities. Such indirect funding by government may be administratively efficient,<sup>115</sup> but lacks transparency.<sup>116</sup> Furthermore, when deductions or tax credits are not subject to a maximum sum, government may be less able to anticipate tax yield.<sup>117</sup> Generous taxpayer concessions may also encourage avoidance schemes, evasion and fraud. IRD has already identified certain generic schemes that are financially neutral between the parties involved but would not be transacted unless the enhanced donations deductions were available.<sup>118</sup> This is not, in itself, an argument

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<sup>110</sup>Robert Murray Haig, 'The Concept of Income' in Robert Murray Haig, Thomas Sewall Adams and Thomas Reed Powell (eds), *The Federal Income Tax* (first published 1921, BiblioBazaar, 2009) 7 defines income as the 'money value of the net accretion to one's economic power between two points of time'. Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 50 defines personal income as 'the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question'.

<sup>111</sup>Dal Pont, above n 34, 448.

<sup>112</sup>William D Andrews, 'Personal Deductions in an Ideal Income Tax' (1972) 86 *Harvard Law Review* 309, 344-375.

<sup>113</sup>Fleischer, above n 95, 10. As Simon et al, above n 70, 274 note, '[i]t is hard to see why a gift to a stranger, poor or rich, is consumption, whereas a gift to charity is not'.

<sup>114</sup>James Andreoni, 'Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving' (1990) 100 *Economic Journal* 464, 473.

<sup>115</sup>See, for example, Industry Commission, *Charitable Organisations in Australia* Report 45 (Australian Government Publishing Services, 1995) 271.

<sup>116</sup>Dal Pont, above n 34, 450.

<sup>117</sup>Ibid. While this does not appear to be a plausible concern in New Zealand at present, charitable deductions may distort democratically negotiated spending patterns: insufficient tax revenue may be available for government projects, while donations are funnelled to the pet causes of the wealthy.

<sup>118</sup>One scheme involves a creditor of the charity, which cannot repay the debt. The creditor makes an additional payment to the charity to allow it to repay the original debt. This transaction only takes place

*Footnote continues over page*

against taxpayer concessions, but, because the administrative costs of policing fraud and evasion should be taken into account, it needs to be asked whether the public benefits gained by the concessions could be achieved in other ways that do not facilitate avoidance, such as direct grants to charities drawn from contestable funds.

#### 4 *Policy Justification*

Currently, insufficient policy analysis exists to justify or deny charitable tax privileges.<sup>119</sup> In particular, it is difficult not to infer a degree of political expediency to the 2008 expansion of donation tax concessions by the Labour-led government at the behest of the ideologically elusive United Future party. Peter Dunne, the sole Member of Parliament for United Future, and Minister of Revenue, described the amending Bill<sup>120</sup> as 'a particular consequence of the confidence and supply agreement between United Future and Labour';<sup>121</sup> he did not, however, plausibly explain the Bill's underpinning policy.

### ***C Preliminary Conclusions and Recommendations***

Gino Dal Pont concludes that, although no one particular theory or argument 'is conclusive in itself, they do combine to form a considerable arsenal against taxing charitable bodies'.<sup>122</sup> However, it is implausible that all of the 25,000 and more registered charities in New Zealand perform universally admired humanitarian functions that deserve public respect and fiscal reward. Indeed, even unimpeachable charities often conflate their uncontroversial charitable work with religious proselytising that is anathema to a secular understanding of charity.<sup>123</sup> Conversely, arguments against tax privileges do not apply to all charities, but do indicate that a more focused approach is needed to establish qualification for tax privileges.

The current system for regulating and taxing the third sector in New Zealand may be optimal. However, it is not possible to know whether charities are, in fact, performing

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because of the ability to claim the tax deduction/credit for the donation. The second scheme relates to the situation where a person intends to donate goods to a charity. Rather than donate the goods, the person donates cash. The charity then purchases the goods that would originally have been donated. See IRD, above n 67. With regard to the second identified scheme, the problem may lie with the law. Analogous to fringe benefits, the value of gifts in kind might be made deductible in the same way as monetary donations.

<sup>119</sup> Dal Pont, above n 34, 450. It is submitted that IRD's 2006 analysis (Policy Advice Division, above n 75), was insufficiently robust in its analysis of arguments against extending tax credits and deductions relative to its 2001 analysis (Policy Advice Division, above n 10.)

<sup>120</sup> Taxation (Business Taxation and Remedial Matters) Bill 2007 (7-109).

<sup>121</sup> New Zealand, *Parliamentary Debates*, House of Representatives, 11 December 2007, 13767 (Peter Dunne).

<sup>122</sup> Dal Pont, above n 34, 448.

<sup>123</sup> For a discussion of non-religious taxpayers subsidising religious organisations as tax-exempt charitable organisations, see Blundell, above n 60, 26-29. Generally, following Wallace, above n 31, Blundell argues that charitable firms enjoy an unfair advantage over for-profit firms, and should at least have their books opened up to public scrutiny: *ibid*, 29. Hansmann (above n 10, 79) also concludes that 'tax exemption - or at least exemption from sales, and, particularly, corporate income taxes - offers nonprofit firms a significant advantage in establishing market share vis-à-vis for-profit firms offering similar services'.

the activities that benefit the general public, and which contemporary society wishes to subsidise, because of the opacity that obfuscates analysis of the sector. It is submitted that, particularly at a local level,<sup>124</sup> there needs to be greater citizen participation in decisions about charities' tax privileges,<sup>125</sup> but before an informed debate can commence, full transparency about which organisations benefit from tax concessions is necessary. In short, sufficient reliable information is not currently available to inform relevant policy.<sup>126</sup> Despite this lack of information, it is submitted that the following recommendations deserve further consideration:

### 1 *Statutory Definition of 'Charity'*

O'Halloran observes that 'the fact that four centuries of charity law has left poverty firmly entrenched in the common law nations raises some basic questions'.<sup>127</sup> So: does the Preamble-derived definition of 'charity' meet contemporary needs or should it be superseded by a statutory definition? Ken Lord and David McLay argue that the lack of a positive statutory definition 'is probably a good thing, even if based on the simple but powerful argument that proscription may unwittingly result in the exclusion of charities which benefit society immensely'.<sup>128</sup> A non-exhaustive definition that may accommodate unforeseen purposes seems uncontroversial, but whether such flexibility should be delivered by the common law or legislation is debatable.

While the Preamble was not a *tabula rasa*,<sup>129</sup> since its enactment, the common law has developed from a particular statute, enacted for particular historical purposes. Thus Fiona Martin observes:<sup>130</sup>

The history of the legal definition of 'charity' shows that this development must be viewed in the context of the economic situation of the seventeenth and eighteenth centuries. Commencing with the Preamble in 1601, it was drafted with the state's agenda for

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<sup>124</sup> Local Government Rates Inquiry Panel, *Funding Local Government: Report of the Local Government Rates Inquiry* (Local Government Rates Inquiry, 2007) 227 noted: 'Almost universally, local government supports removing statutory exemptions and having the power to determine what land should continue to be exempt. Local government would exercise this power through its rates remission policies.'

<sup>125</sup> The 'tyranny of the majority' could result in minority-oriented charities being disfavoured, but New Zealand has robust anti-discrimination legislation, procedures, and culture to render this a minor consideration. Besides, government can also make good the gaps in charitable delivery.

<sup>126</sup> The making available of charities' annual reports by the Charities Commission is a significant step towards transparency, but both government and the charities themselves need to do more in showing how they benefit from tax revenue and how they promote public benefit. Dervan above n 29, 54 notes that leading independent schools in the United Kingdom voluntarily (and prudently) publish on their websites how they meet the public benefit criterion, and argues that since 'such schools receive fiscal benefits, there is no reason why this information should not be public'.

<sup>127</sup> O'Halloran, above n 33, 17.

<sup>128</sup> Ken Lord and David McLay, *Charities Act 2005: The New Deal* (New Zealand Law Society, 2006) 4. However, the common law framework has operated to obstruct philanthropic activity on behalf of the socially disadvantaged Māori. See Policy Advice Division, *Government Discussion Document No 2 of the Tax Simplification Series: Taxation of Māori Organisations* (IRD, 2001).

<sup>129</sup> According to W K Jordan, *Philanthropy in England 1480-1660: A Study of the Changing Pattern of English Social Aspirations* (Russell Sage Foundation, 1959) 112, the Preamble was notable because it codified 'a body of law badly wanting classical statement'.

<sup>130</sup> Martin, above n 40, 324 (footnotes omitted).

charitable giving in mind, rather than contemplating a list of altruistic purposes that were considered worthy of charitable relief. When drafting the Preamble, the government did not consider from a public policy perspective which areas were important for the benefit of its citizens, but, rather, listed Elizabethan political, economic and social programmes with government hoping that the wealthy would be encouraged to implement and fund these particular areas in order to relieve them from this necessity.

A serious challenge was made to charities' tax privileges by William Gladstone, who, as Chancellor of the Exchequer in 1863, sought to limit the exemption to the relief of hospitals, colleges and almshouses.<sup>131</sup> Significantly, his rationale was 'that the original exemption had been warranted at a time when the state made no provision for education or for the poor and that the situation in 1863 was very different, and therefore the exemption was no longer needed'.<sup>132</sup> If broad tax concessions could be considered out of date in the mid-nineteenth century, it seems they might appear positively obsolete in a contemporary context. Indeed, in the heyday of the welfare state in the forty year period following the Second World War, the idea of a third sector in New Zealand making good the gaps in the provision of public goods and services may have seemed archaic. However, with the retreat, albeit not withdrawal, of the State from direct welfare provision since the mid-1980s, the role of the third sector has been re-emphasised.

The common law may be sufficiently flexible to allow some expansion of the scope of charitable purposes so as to meet the social values and attitudes prevalent in a particular society,<sup>133</sup> but adherence to the common law in New Zealand has left charitable law 'largely unchanged in terms of its capacity to address contemporary social inclusion issues'.<sup>134</sup> Furthermore, it is not obvious that the common law is capable of removing antiquated charitable purposes — religious proselytising being the most archaic purpose from a secular perspective.

The common law is complex and, not being codified, difficult to access without specialist knowledge. Consequently, 'charitable' in the legal sense does not correspond with the popular understanding of 'eleemosynary' (alms giving).<sup>135</sup> 'The current meaning of charity and charitable purpose is largely defined at common law, which has developed over 400 years. As a result the law can often be confusing and unclear'.<sup>136</sup> Indeed, Lord Simonds, contemplating the common law on charities, observed in *Oppenheim v Tobacco Securities Trust Ltd* '[n]o one who has been versed for many years in this difficult and very artificial branch of the law can be unaware of its illogicality'.<sup>137</sup>

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<sup>131</sup> Ibid, 309.

<sup>132</sup> Ibid.

<sup>133</sup> *Centre Point Community Trust v CIR* [1985] 1 NZLR 673, 679.

<sup>134</sup> O'Halloran, above n 33, 309.

<sup>135</sup> Dal Pont, above n 34, 8.

<sup>136</sup> Australian Treasury, *A Definition of Charity: Consultation Paper* (2011) [http://www.treasury.gov.au/documents/2161/PDF/definition\\_v6.pdf](http://www.treasury.gov.au/documents/2161/PDF/definition_v6.pdf) (no longer operative). This document has since been archived: see [http://archive.treasury.gov.au/documents/2161/PDF/definition\\_v6.pdf](http://archive.treasury.gov.au/documents/2161/PDF/definition_v6.pdf).

<sup>137</sup> *Oppenheim v Tobacco Securities Trust Ltd* [1951] AC 297, at 307.

Adoption by the early colony of the English common law and equity,<sup>138</sup> albeit 'so far as applicable to the circumstances' of the country,<sup>139</sup> impacts on the contemporary formulation, operation and strategies of New Zealand charities. And so, while New Zealand continues to develop as a distinctive common law patois,<sup>140</sup> English law 'is generally considered to set out the principles of charity law in New Zealand'.<sup>141</sup> Furthermore, despite recent reforms, the 'Charities Act 2005, on the face of it, has left charity law in New Zealand anchored to its common law legacy'.<sup>142</sup> In *Commissioner of Inland Revenue v Medical Council of New Zealand*, Justice Thomas held that the 'spirit and intendment' rule should be used with more attention to contemporary circumstances than to case precedent.<sup>143</sup> This relaxation of the public benefit test to accommodate 'other purposes beneficial to the community' indicates the flexibility of the common law in the hands of a progressive jurist.<sup>144</sup> However, a contemporary legislative definition of 'charity' informed by current needs and aspirations, and public consensus, seems desirable. In response to the difficulties arising from adherence to a common law conception of charity, the Australian Treasury argues:<sup>145</sup>

A statutory definition of charity will allow Parliament to more easily alter the definition over time to ensure that it remains appropriate and reflects modern society and community needs, rather than having the common law being developed only by the courts as an ad hoc, costly and time consuming process.

This argument appears plausible,<sup>146</sup> provided that the legislative process is not subject to undue lobbying and the influence of special interest groups.

## 2 Filing

Since charities are not required to file income tax returns if all their income is exempt,<sup>147</sup> the total amount of income which is not subject to tax cannot be established. While this concession simplifies compliance and minimises administration costs, it also ensures an

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<sup>138</sup> As Justice Denniston observed in *Re Dilworth (Deceased)* (1896) 14 NZLR 729, 735: 'It would be absurd to contend that, apart from any legislation in New Zealand, a bequest for charitable purpose by a testator in New Zealand would be interpreted by any other standard than that of the measure of the same words in English law.'

<sup>139</sup> See consolidation by *English Laws Act 1908* (NZ) s 3. *Imperial Laws Application Act 1988* (NZ) s 5 perpetuates the application of the common law and equity (to charities). The most obvious accommodation of local circumstances in New Zealand charity law lies in the acceptance that Māori charities often benefit blood relations; charity may be said to start on the *marae* (community meeting place). See, in particular, *Income Tax Act 2007* s YA 1 definition 'charitable purpose' para (b).

<sup>140</sup> See, for example, Michael Taggart, 'The New Zealandness of New Zealand Public Law' (2004) 15 *Public Law Review* 81, 81-86.

<sup>141</sup> Lord and McLay, above n 128, 4.

<sup>142</sup> O'Halloran, above n 33, 309.

<sup>143</sup> *Commissioner of Inland Revenue v Medical Council of New Zealand* [1997] 2 NZLR 297.

<sup>144</sup> O'Halloran, above n 33, 288

<sup>145</sup> Australian Treasury, above n 136.

<sup>146</sup> A statutory definition of 'charity' was included in the *Charities Act 2006* (UK). Despite this innovation, in the view of Garry Runciman, '[c]harity law is a mess.' See W G Runciman, 'The Charity Mess' (2012) 34(14) *London Review of Books* 20, 20.

<sup>147</sup> See above n 9.

unacceptable degree of opacity. Filing should be an obligation.<sup>148</sup> Regular monitoring should also be conducted to ensure that the charitable objects for which their tax exemptions were granted are, in fact, being pursued.<sup>149</sup>

### 3 *Neutrality*

It is widely believed that, by virtue of tax concessions, charities gain an unfair advantage when they operate in the same markets as commercial entities.<sup>150</sup> There can be little doubt that the rating exemption enjoyed by many charities 'because it reduces input costs, assists a non-profit in a contest with taxable competitors'.<sup>151</sup> The principle of neutrality implies that tax advantages for charities should be denied when they compete in the same field of enterprise as profit-seeking firms;<sup>152</sup> conversely, the latter might attract the same tax advantages when performing similar functions to charities.<sup>153</sup> Certainly, FBT concessions, which might attract employees to charities from profit-seeking firms, should be phased out.<sup>154</sup> Trading operations of charities could be subject to income tax in the normal way, and like any other company, they could claim unlimited deduction of charitable donations.<sup>155</sup> At first face, then, firms affiliated to charities should be treated in precisely the same way as ordinary companies.<sup>156</sup> However, Eleanor Brown and Al Slivinski argue that charitable firms typically do not have a pure profit motive; they do not behave in the same way as profit-seeking firms; in short, '[n]onprofit firms are not, in general, for-profits in disguise'.<sup>157</sup> Furthermore, John Colombo argues:<sup>158</sup>

the criterion that can and should be used to judge exempt status in these cases of "commercial similarity" is whether the organization provides access to services for previously-underserved populations or provides specific services to the majority population that otherwise are not provided by the private sector.

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<sup>148</sup> Policy Advice Division, above n 10, 9 contemplated that tax returns would be 'possibly' filed.

<sup>149</sup> *Ibid*, 10.

<sup>150</sup> Dal Pont, above n 34, 448.

<sup>151</sup> Simon et al, above n 70, 288.

<sup>152</sup> See, Ross Report, above n 10, 312–313.

<sup>153</sup> For a discussion, see Anyp Malani and Eric A Posner, 'The Case for For-Profit Charities' (John M Olin Law & Economic Working Paper No 304, University of Chicago Law School, 2006) <[http://ssrn.com/abstract\\_id=928976](http://ssrn.com/abstract_id=928976)>.

<sup>154</sup> Policy Advice Division, above n 10, 10. As noted, this did not happen. Policy Advice Division, *Recognising Salary Trade-offs as Income* (IRD, 2012) 17 recommended bringing salary trade-offs and voucher schemes into the FBT net for employees of charities. On phasing out FBT concessions for charities in Australia, see Productivity Commission, *Contribution of the Not-for-Profit Sector* (2010) <<http://www.pc.gov.au/projects/study/not-for-profit/report>> 211–218.

<sup>155</sup> cf Policy Advice Division, n 10 above, 43.

<sup>156</sup> In 1987, the neoliberal Labour government announced radical plans, including a flat income tax and for charities to be taxed in the same way as companies. Neither proposal was enacted.

<sup>157</sup> Eleanor Brown and Al Slivinski, 'Nonprofit Organizations and the Market' in Walter W Powell and Richard Steinberg (eds), *The Nonprofit Sector: A Research Handbook* (2nd ed, Yale University Press, 2006) 140, 154.

<sup>158</sup> John D Colombo, 'The Role of Access in Charitable Tax Exemption' (2004) 82(2) *Washington University Law Review* 343, 345.

In short, the principle of neutrality is not controversial; what is problematic is demonstrating that for-profits and charitable firms are equally situated, and therefore warrant equal treatment.

Neutrality between charities and the government agencies with which they may compete in providing social services should also be considered. On the one hand, their apparently equal situation may support arguments for tax-free status for charities, but arguably the more pertinent neutrality consideration raised here relates to citizen rights and accountability. If charities compete with government agencies, they should be subject to similar accountability disciplines as the public sector.

## V CONCLUSION

Contemplating the American third sector, but expressing a sentiment relevant to New Zealand, Roger Colinvaux argues that the time is ripe 'to begin developing a clearer idea of the type of organisation that should be supported by the tax system, and, critically, to what extent'.<sup>159</sup> This article has outlined the development of the common law conception of charity and charitable tax concessions in New Zealand. Without gainsaying the socially invaluable work performed by many charities, charitable tax policy is not well informed.<sup>160</sup> Efficiency and neutrality, two of the pillars of good tax policy, remain mostly unexamined in relation to charitable concessions. In the wake of the global financial crisis and increasing socio-economic inequality, government must, on the one hand, ensure there is no unjustifiable leakage from the treasury, but on the other hand, avoid exacerbating the plight of those worst off in society, who are typically the beneficiaries of charities' endeavours. It is politically implausible to think that government might remove tax privileges from all charities, indeed, tax concessions once enacted tend to become entrenched. However, while these substantial benefits merit reconsideration, such a review is not possible without the transparency that is currently lacking in the New Zealand third sector.

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<sup>159</sup> Roger Colinvaux, 'Charity in the 21<sup>st</sup> Century: Trending Toward Decay' (2011) 11(1) *Florida Tax Review* 1, 70.

<sup>160</sup> 'In every jurisdiction except the United States, there has been **remarkably little substantive literature on the taxation concession.**' See Not-for-Profit Project, above n 69, 3 (emphasis in original).



**AUSTRALIA'S PROPOSED UNRELATED COMMERCIAL ACTIVITIES TAX:  
LESSONS FROM THE U.S. UBIT**

MICAH BURCH\*

**ABSTRACT**

After announcing its intention to tax income from the unrelated commercial activities of not-for-profit entities in its 2011-2012 budget, the Australian government delayed by a year (to 1 July 2012) the start date for its *Better Targeting for Not-For-Profit Tax Concessions* reforms. The delay is in response to the not-for-profit sector's desire for further consultations before implementation and offers a welcome opportunity to reconsider the measure in light of the US experience with a similar tax provision. This article outlines some problems with the justifications for, and implementation of, the planned reform.

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## I INTRODUCTION

The Australian Government intends to introduce legislation imposing tax on the income of a not-for-profit entity ('NFP') derived from commercial activities unrelated to the entity's charitable purpose. This article considers certain aspects of the proposed unrelated commercial activities tax ('UCAT') in light of the key (putative) policy justifications for such a tax and the sixty years of experience with a similar (though not identical) tax in the United States — the unrelated business income tax ('UBIT'). In particular, the article looks at historical and political issues surrounding the enactment of the proposed tax, the seemingly unkillable 'competitive neutrality' rationale for subjecting otherwise exempt entities to income tax on their unrelated commercial activities, and some observations regarding practical concerns such as the complexity, administrability, inefficiency, and revenue effects of such a tax. There are a number of articles, in Australia and overseas, that canvass the tax policy concerns more fully, and which provide in-depth analysis of particular aspects of Australia's larger NFP reform initiative.<sup>1</sup> This article highlights issues that especially benefit from a comparison between Australia's proposed UCAT and the United States UBIT.

## II WORD INVESTMENTS

The last five years have seen a flurry of activity and commentary regarding the regulation of not-for-profit entities in Australia, kicked off in 2008 when the High Court decided *Commissioner of Taxation v Word Investments Ltd* ('Word').<sup>2</sup> The case involved a religious organisation (Wycliffe Bible Translators Australia, a tax-exempt missionary and bible translation organisation) that operated a business (Word Investments, a for-profit funeral and investment business) in a purely commercial manner. After having their application for recognition of charitable status rejected by the Commissioner, the business successfully argued up to the High Court that it was entitled to status as a charitable institution for the purposes of income tax concessions on the basis that the income derived from its commercial activities was used simply as a means to the end of furthering the entity's sole and exempt purpose of advancing religion. The majority found that 'Word endeavoured to make a profit, but only in aid of its charitable purposes.'<sup>3</sup>

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<sup>1</sup> See, eg, Joyce Chia and Miranda Stewart, 'Doing Business to Do Good: Should We Tax the Business Profits of Charities and Not for Profits?' (2012) [unpublished paper]; Kerrie Sadiq and Catherine Richardson, 'Tax Concessions for Charities: Competitive Neutrality, The Tax Base, and "Public Goods" Choice' (2010) 25(4) *Australian Tax Forum* 401. 'The proposed UCAT is just one part of a comprehensive review and reform of Australian NFP regulation. The reform also calls for, *inter alia*, a new standalone regulatory oversight commission (the Australian Charities and Not-for-Profits Commission, to be established by 1 October 2012) and a statutory definition of 'charity' (announced July 2012, effective one year hence).

<sup>2</sup> *Commissioner of Taxation v Word Investments Ltd* [2008] HCA 55 See, eg, Ian Murray, 'Charity Means Business: *Commissioner of Taxation v Word Investments Ltd*' (2009) 31(2) *Sydney Law Review* 309.

<sup>3</sup> *Ibid* [24]. The decision in *Word* read the business's organisational documents to evince an overall charitable purpose (advancing religion) and read down individual matters that, considered on their own were beyond the true purpose, to be *powers* available in furtherance of the overall purpose: *Ibid* [23].

The holding in *Word*, which in many respects merely confirms existing law, recalls the state of play in the United States tax-exempt sector before the enactment of the UBIT in 1950. Before that time, the 'destination of income' doctrine, established by the Supreme Court in 1924 in *Trinidad v Sagrada Orden de Predicadores*,<sup>4</sup> determined eligibility for tax exemption based on the destination and not the source of income. Thus, an organisation (including a purely profit-seeking venture) could donate all of its profit to charity and thereby eliminate its tax liability (as is currently the case under Australian tax law for certain NFPs), which simulates the effect of being exempt from tax. But with the introduction of the UBIT came a statutory denial of exemption for 'feeder organisations' that primarily carry on a business for profit but then donate all such profit to exempt organisations.<sup>5</sup>

### III US UBIT: HISTORY AND POLICY

If *Word* was the prompt for tangible reform in Australia, then New York University's ownership of the Mueller Macaroni Company (the profits from which supported the law school) was the lightning rod for the storm that led to the replacement of the 'destination of income' doctrine with the UBIT in the United States. Mueller's acquisition in 1947 by NYU complemented other commercial holdings of the university, including a leather company, a chinaware company, and a manufacturer of piston rings.<sup>6</sup> The popular press raised the alarm regarding abuse of the income tax exemption by charitable organisations and the growing controversy led in short order to hearings in the House Ways and Means Committee regarding concerns over unfair competition by charities.

In 1950, President Truman proposed the UBIT, saying that the tax exemption was being used to 'gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to [the exempt purpose]'.<sup>7</sup> The reports of both houses of Congress on the bill emphasised that the mischief being addressed was primarily unfair competition.<sup>8</sup> During congressional debate, influential Representative John Dingell warned that 'the macaroni monopoly will be in the hands of the universities'.<sup>9</sup>

Congress passed the UBIT into law and implementing Treasury Regulation § 1.513-1(b) unambiguously lays out that the 'primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non exempt business endeavours with which they compete'.

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<sup>4</sup> 263 US 578 (1924).

<sup>5</sup> IRC §502 (2012).

<sup>6</sup> Stephen Schwarz, 'Federal Income Taxation of Investments by Nonprofit Organizations: Beyond a Primer' (2000) <http://www1.law.nyu.edu/ncpl/pdfs/2000/Conf2000SchwarzPaper.pdf>, citing Donald L. Sharpe, 'Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later' (1996) 3 Florida Tax Review 367, 380-383.

<sup>7</sup> House of Representatives Document No. 81-451 [1950] 5.

<sup>8</sup> House of Representatives Document No. 81-2319 [1950] 409; Senate Report No. 81-2375 [1950] 504.

<sup>9</sup> Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Congress 580 (1950) (statement of Rep. John Dingell).

The UBIT, found in §§ 511–514 of the Internal Revenue Code, generally imposes income tax at the corporate tax rate on the unrelated business income of certain tax-exempt entities. The business income must arise from a trade or business that is regularly carried on by the charity and is unrelated to its purposes. Section 513 defines ‘unrelated trade or business’ as ‘any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption ...’. UBIT does not apply to a long list of exempted types of unrelated passive income including dividends, interest, loan proceeds, annuities, royalties, rents from real property, capital gains, and certain other types of income such as research income.<sup>10</sup> Additionally, any kind of investment income is subject to UBIT to the extent that it is debt-financed.<sup>11</sup>

As discussed below, the UBIT in theory and in practice is not adequately justified by a concern for competitive fairness between NFPs and for-profit entities. Ethan Stone has posited that the political expediency of this fallacious rationale, along with deeply conflicting societal attitudes toward the proper role of society’s ‘third sector’, account for the longevity of the UBIT without regard to thoughtful tax policy analysis.<sup>12</sup> According to Stone’s analysis, the UBIT was simply a politically expedient way to attempt to reign in charitable behaviour that exposed the ‘dissonance’ between the presumptive basis for the exemption generally (the exempted entities’ supposed commitment to the performance of ‘good works’) and the problematic activities being notoriously undertaken by some NFPs.<sup>13</sup> The UBIT could be said to address the concerns over NFP malfeasance without actually threatening what was an entrenched and fundamental policy (of exempting legitimate charities and their activities in furtherance of their exempt purpose). The contours of the rules, which distinguish between related and unrelated income, and passive and active income, cannot be justified based on the given tax policy grounds of competitive neutrality (or other related grounds), but can be rationalised based on an appreciation for the symbolism of charities and their undertaking of particular activities. As Stone observes, ‘Active business endeavors present symbolic problems that passive investments do not’.<sup>14</sup> Implicitly, the same could be said for both related and unrelated activities.

Evelyn Brody also identifies the ambivalence at the core of policy discussions regarding charitable entities. There is a sense in which it just seems wrong to tax charitable entities and she attributes this to their similarity to independent sovereigns, especially inasmuch as the general view of charities as exceptional is rooted in historical and internalised views of the role of religion (specifically, the church).<sup>15</sup> The UBIT, then, can be seen as a way of one sovereign limiting the undue expansion of the activities of

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<sup>10</sup> IRC §512(b) (2012).

<sup>11</sup> IRC §514 (2012).

<sup>12</sup> Ethan Stone, ‘Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax’ (2005) 54 *Emory Law Journal* 1475.

<sup>13</sup> *Ibid* 1550–1553.

<sup>14</sup> *Ibid* 1545.

<sup>15</sup> Evelyn Brody, ‘Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption’ (1997) 23 *Journal of Corporation Law* 585, 605–606.

another sovereign (made up of societal structures outside the market and government, such as charity and religion).<sup>16</sup> Even though churches, among others, were not originally subject to the UBIT, the tax was extended to all tax-exempt entities in the 1969 tax reform.<sup>17</sup> The way in which the UBIT came about can perhaps best be understood as a response to a perceived problem at a particular historical moment, and as such is reflective of deeply held historical assumptions.

A historical consideration of the UBIT adds a valuable insight to the knotted tax policy debate over the issue, which seems stuck. Though not often appropriate in discussions regarding tax policy, considerations of historical context are germane when considering the tax treatment of NFPs, especially charities and religious organisations, whose unique role has always been recognised. A similar examination of the Australian UCAT proposal (and that which prompted it) might shed some light on the underlying concerns animating the tax, and thereby provide a better basis upon which to evaluate the proposal, both on its own terms and in the context of the larger NFP reform agenda.

#### IV UCAT

The UCAT differs from the UBIT in that the UCAT is intended to apply only to retained unrelated profits of NFPs (whereas the UBIT applies to unrelated income whether retained or not). It is thus worth recalling that the outcome sought by the taxpayer in *Word*, namely tax-exemption for business profits ultimately put to charitable use, could already be achieved under existing law for many types of NFPs. For example, a charity may operate an unrelated business through a subsidiary that pays a franked dividend to the charity, which is eligible for a refund of the franking credits (if it is a qualifying NFP). Under s 207-115(2) of *Income Tax Assessment Act 1997* (Cth), only charitable institutions and certain charitable funds are eligible for a refund of franking credits; religious, scientific, and public educational institutions are not. Alternatively, the subsidiary business could make a tax-deductible donation of all of its income to the charity, if the charity qualifies as a deductible gift recipient ('DGR'). Although a wide variety of charities can qualify as a DGR, churches generally do not qualify and a variety of other NFPs are unlikely to qualify for the benefits of either structure (for example, arts organisations, community service organisations, and sporting clubs).

Nonetheless, for a large portion of NFP entities the outcome approved in *Word* was already possible. *Word* did not by itself usher in a sea change in the way NFPs fund themselves. It did, however, confirm that certain organisations that were not favoured by the statutorily approved techniques for obtaining tax-free funding from unrelated business activity could nonetheless achieve such an outcome.

In the same way that NYU operating one of the largest macaroni operations in the United States simply did not meet expectations of the proper societal role for tax-exempt organisations, the response to *Word*, in the form of the UCAT, seems to be motivated less

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<sup>16</sup> Ibid at 606–607.

<sup>17</sup> Stone, above n 12, 1484–1488. In fact, as early as the 1947 congressional hearings instigated by NYU's macaroni deal, there was concern about charities taking over, and domination by the church as in medieval times. Ibid n 61 and accompanying text.

by pure tax policy concerns and more by concerns that evangelical groups can operate for-profit funeral and investment businesses tax-free and the Seventh Day Adventists (through their Sanitarium brand of health foods, including most notably, breakfast cereal) can rival Kellogg's in revenue without paying company income tax.

## V COMPETITIVE ADVANTAGE?

If the UBIT and the UCAT both arose due to similar concerns regarding the proper role of charities, their justifications were tactically similar as well. Just as the UBIT was introduced ostensibly to prevent unfair competition by treating the unrelated business activities of exempt entities in the same way for income tax purposes as the for-profit businesses with which they compete, the Australian Treasury's recent Consultation Paper in relation to the UCAT states that it is meant, in large part, to create 'a level playing field for all small, large and NFP businesses in Australia'.<sup>18</sup>

This despite the fact that the 'competitive neutrality' justification has been persuasively challenged by economists, legal scholars, and even recent government studies discussing Australian NFP reform. The Henry Review concludes that 'NFP organisations should have scope to conduct commercial activities freely. This approach ... would reflect the principles of the High Court of Australia's *Word Investments* decision.'<sup>19</sup> Similarly, the 2010 Productivity Commission found that the income tax exemption generally does not violate notions of competitive neutrality: '[O]n balance, income tax exemptions are not significantly distortionary as not-for-profits have an incentive to maximise the return on their commercial activities that they then put towards achieving their community purpose.'<sup>20</sup>

This last statement gives the lie to the most commonly identified competitive advantage supposedly provided by tax exemption: that it provides exempt entities better cash flow compared to that of for-profit competitors, allowing the otherwise identical business owned by a tax-exempt to either expand more quickly or engage in predatory or anti-competitive pricing. With regard to the former danger, the proposition fails to account for the fact that, unlike for-profit businesses, NFPs cannot access equity capital markets as a source of funding. With regard to the latter, as noted above, presumably NFPs engaging in commercial activity do so with the same goal of maximising pre-tax profit as any other business, and are thus unaffected by tax (under certain assumed simplifying conditions, at least) in their investment decisions.

A slightly less intuitive competitive concern is the effect of tax (or tax exemption, as the case may be) on a potential investor's valuation of a given investment. The concern is that, because tax-exempts receive higher cash flow from an investment than taxable entities would receive from the same investment (because of tax), NFPs will be able to outbid for-profit businesses for that investment. Michael Knoll's comprehensive analysis of this claim shows that it fails to consider the interaction between each entity's discount

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<sup>18</sup> Australian Treasury, *Better Targeting of Not-For-Profit Tax Concessions* (Consultation Paper, 27 May 2011) [8] ('Consultation Paper').

<sup>19</sup> Commonwealth, *Australia's Future Tax System* (2009) ('Henry Review') B3-3.

<sup>20</sup> Productivity Commission, *Contribution of the Not-for-Profit Sector* (2010) 197, 203-205.

rate and the valuation of alternative investments. Knoll illustrates the analysis with a simple hypothetical.<sup>21</sup> Assume a particular investment yields a \$100 annual return. If a for-profit firm makes the investment, its after-tax annual return, assuming a tax rate of 30%, is \$70 while the tax-exempt investor keeps the full \$100 return each year. In deciding whether or not to make the investment, both firms will value it on a present value basis, using its own particular discount rate. If the going market return on the next best investment alternative is 10%, the for-profit's after-tax return on such an alternative investment is 7%, and that is the for-profit entity's after-tax discount rate. Its annual after-tax return of \$70 will be discounted at 7%, yielding a present value of \$1,000 (assuming the returns are perpetual) over the life of the investment. For the same investment, the tax-exempt's after-tax return is 10%, as it pays no tax on the alternative investment either. The tax-exempt's discount rate is thus 10%, and the \$100 after-tax return would be valued in present value terms also at \$1,000.

Because both potential investors value the target investment equally in present value terms, there is no advantage caused by tax. In short, relative tax rates do not affect how an investor values potential investments. While a tax-exempt might enjoy greater cash flow from a given investment, it will also enjoy greater cash flow from any other investment — and the two effects cancel each other out from a competition perspective. To the extent that UBIT is imposed on an investment, the tax-exempt investor will value it lower than a for-profit investor values it (because the tax-exempt investor's discount rate is still the before-tax return obtainable from investments to which the UBIT does not apply), and thus the UBIT actually creates a competitive advantage for for-profit firms with respect to unrelated business. In an influential article, Susan Rose-Ackerman further shows that, if anything, UBIT increases competition in areas *related* to the NFP's exemption as it discourages unrelated business activity.<sup>22</sup>

Nonetheless, the continued currency of the unfair competition rationale in the public debate and perception surrounding the issue of taxation of NFPs warrants some further attention. Even if competitive neutrality is not a legitimate underlying concern (to the extent there can ever be a singular motivating rationale for complex statutory law), and even if in some circumstances, or under relaxed assumptions, NFPs do actually enjoy a tax-induced advantage, the countervailing interests identified in response to such concerns are instructive for policy considerations going forward.

The UCAT proposal is premised on the concern identified in the Henry Review that the ability of NFPs to use their retained untaxed business income to subsidise further investment is in fact an advantage for NFPs. Even if true, there are a number of reasons why we might allow or even encourage such an advantage. The issue of tax exemption is fundamentally predicated upon the notion that NFPs provide valuable public goods that, because of market failure, would not otherwise be produced by the public sector (and would otherwise presumably be provided by government, if at all). There is an extensive literature on the nature of such 'positive externalities', and they include matters both

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<sup>21</sup> Michael Knoll, 'The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?' (2007) 76 *Fordham Law Review* 857, 866–871.

<sup>22</sup> Susan Rose-Ackerman, 'Unfair Competition and Corporate Income Taxation' (1981) 34 *Stanford Law Review* 1017, 1038–1040.

tangible (the ability to provide underprovided public goods, to serve different clienteles and to operate using more socially useful criteria than pure profit maximisation) and abstract (greater community engagement and participation, the 'warm glow' created by a society that prioritises charity and public-minded endeavours, the creation and bolstering of societal values and social interconnectivity, and even simple diversity). Also, as mentioned above, there are many tangible ways in which NFPs are disadvantaged, and so tax concessions can be seen as offsetting such disadvantages.

To the extent that they are true, these rationales for the different tax treatment of NFPs relative to for-profit entities might go further than simply negating the argument that tax exemption is anti-competitive. Along with the fallacy of the assumptions required to make the market model justifiable, these rationales raise the question of whether it would indeed be a bad thing if we did in fact provide NFPs (carefully defined, of course) with a competitive advantage. Despite internally consistent, economics-based arguments predicated on the market capitalism model, the unreality of the assumptions raises the question of what exactly would be the problem if charities outcompeted for-profit entities in certain industries. Putting the thorny issue of religion aside, it is not clear to this author that society would necessarily be worse off if, say, charities concerned with health and the environment outcompeted corporate giants in the breakfast cereal market.

This is a particularly controversial line of inquiry, and perhaps one that has more rhetorical promise than theoretical legitimacy. But this line of inquiry is worth bearing in mind when one considers the taxation and regulation of the third sector more generally, especially given that market imperfections are increasingly obvious, government's ability to ameliorate inequality is limited, and societal views toward government and the market are at least as important as increasingly chimeric optimal tax policy concerns. After all, convincing arguments based on economics and tax policy apparently have not yet sufficed to win over policymakers and the public.

Given the array of societal attitudes toward, and tax rules regarding, the various sources of funding potentially available to NFPs (ie donations, active business activity — related or unrelated, passive investment, direct funding, etc), it is important to at least ask a related question: if it is justified to subsidise NFPs via the tax system, is it necessarily better to subsidise donations, for example, to a greater extent than competitive business operations? The potentially anti-democratic aspect of donative funding is problematic; are we more concerned with antitrust? The issue might be more usefully examined as a question of the optimal source of funding for socially desirable not-for-profit activity.

What we think as a society about the NFP sector has become complex and muddled, but its thoughtful consideration, and a consistent application of principles, is integral to the coherence and effectiveness of major reforms, including tax reforms. The taxation of NFPs must be considered along with the rest of the reforms in this area of law (particularly the definition of charity). There is a feedback loop of sorts: the high-level policy concerns should guide the structure and workings of the regulatory apparatus, but the workings of, say, the tax law can also reflect back upon, and inform, the high-level policy concerns.



## VI LINE-DRAWING PROBLEMS

Assuming (as we often do in tax) that the policy issues are or can be sufficiently sorted out, it is also worth considering the UCAT proposal with regard to more instrumentalist tax policy concerns such as administrability and compliance, complexity, inefficiency, and, of course, revenue effects. In these regards the UBIT experience can also be instructive — and discouraging for the proposed UCAT.

As mentioned above, the UCAT is not a copy of UBIT and one fundamental difference is the UCAT's focus on *retained* unrelated profits in particular. To the extent that the proposal is a reaction to the holding in *Word*, it is worth noting that the decision itself accepted that retention of profits in and of itself does not endanger an NFP's exempt character. And the ATO acknowledges that it is acceptable to retain profits for the purpose of providing even more public good in the future.<sup>23</sup> NFPs engaging in ambitious large-scale projects might need years of capital investment in order to carry out such projects. They also need to save for a rainy day, in case, for example, other sources of funding should decline or a greater need for their services arise. At any rate, the concern with retention, on its own, would seem to apply equally to related business income. Here one can see the considerable problems with line-drawing, the complexity of the tax law, and its effects on administration and compliance costs. Controversy and uncertainty over the contours of the meaning of 'retained' are likely to be as severe as those regarding the distinction between 'related' and 'unrelated' activity.

Like the UBIT, the UCAT proposal depends upon identifying *unrelated* business income. Doing so is costly and complex. US Treasury Regulation § 1.513-1(d)(2) says that business is 'related' to an exempt purpose if it 'contribute[s] importantly to the accomplishment of the exempt purposes'. In one notorious example, the IRS advised that a museum's gift shop sales of home furnishings resembling those on display at the museum were related, while its sales of soap and perfumes were not substantially related to the museum's exempt educational purpose.<sup>24</sup> Further guidance was also required to identify as 'unrelated' the sale of items whose designs merely interpret museum collection pieces, and as 'related', the sales of reproductions and adaptations of items in the museum's collection.<sup>25</sup> The issue is a litigious one involving complicated factual scenarios and difficult, if not inevitably arbitrary, line-drawing exercises that are inefficient for NFP entity and revenue authority alike. What should we make of Sanitarium's argument that the sale of vegetarian food products furthers a religious tenet of Seventh Day Adventism?

A similar characterisation fiasco might also arise with respect to the exemption for passive income. Particular items identified as passive can be problematic; the UBIT exception for royalties, for example, provides NFPs with huge profit opportunities, as does the exemption for real property rents (an area where there actually could be a tax advantage provided to tax exempts). Internal Revenue Code § 513 (and the regulations promulgated thereunder) provide a cornucopia of other quirky exceptions. Even for

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<sup>23</sup> Australian Tax Office, *Income Tax and Fringe Benefits Tax: Charities*, TR 2011/4 [202], 12 October 2011.

<sup>24</sup> Internal Revenue Service, Private Letter Ruling 8605002, 4 September 1985.

<sup>25</sup> Internal Revenue Service, Private Letter Ruling 9550003, 18 September 1995.

investments that are unarguably passive, arguments regarding the distortionary effects of differential taxation would apply. As would other policy concerns implicated by active business: it was, after all, seemingly safe passive investments by charities, such as those made with Bernie Madoff, that led to the demise of many American charities. It may be the case that passive investment is equally, if not more, dangerous than active business in terms of mission creep, as the former has the potential to de-focus organisational attention on proper stewardship of the entity's purposes.

It was criticism of the universities' participation in active investments that led to the UBIT originally; but recent complaints in the United States regarding tax concessions offered to NFPs such as universities often focus on their excessive *passive* investments. It is not clear what policy objective is being pursued by such line-drawing; certainly not competitive neutrality. At any rate, a more useful tool for addressing changing concerns over NFP behaviour already exists: charities that stray from their purpose by engaging in unrelated activity to the extent that they no longer can be said to be primarily pursuing their exempt purpose can still lose their exemption entirely.

Finally, the related issues of the revenue effects of a proposed UCAT and the inefficiently induced tax planning response should be mentioned. United States NFPs subject to the UBIT view it as toxic — as much for the reporting requirements as for the tax burden. They engage in vast amounts of tax planning that surely waste as many dollars in fees and opportunity costs as are saved in tax. Though not said with scholarly authority, the UBIT seems to be a hyper-salient tax. 2008 IRS statistics<sup>26</sup> show that the large majority of NFPs who report unrelated business activity do not actually pay any UBIT whatsoever. Similarly, it is hard to imagine a significant revenue gain from the UCAT. In the face of all of the above criticisms, and more, the foregoing facts further suggest both wasteful planning opportunities and revenue irrelevance. Australia's 1995 Industry Commission report concluded that an unrelated business income tax would be 'complex, rarely used and generally ineffective.'

Reflexive legislative responses to narrow perceived mischief inevitably expand and become entrenched, subjecting a whole range of entities to a complex regulatory regime that has not only known inconsistencies but will undoubtedly have further unforeseen and unintended consequences upon implementation. The cost and trouble for both taxpayers and the ATO of the UCAT must be weighed not only against the measurable benefits, but also against unquantifiables such as the proper relationship between government, the market, and the NFP sector. The task is daunting, and as evidenced by the United States UBIT at least, has proven too much for tax policymakers. Australia's proposed UCAT should be evaluated as part of the overall NFP reform agenda, bearing in mind not just matters of tax policy but also historical, political, and philosophical concerns. In the end, such a tax should be considered carefully — its history is one of poor execution of unclear policy goals.

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<sup>26</sup> Available at <[http://www.irs.gov/uac/SOI-Tax-Stats---Exempt-Organizations'-Unrelated-Business-Income-\(UBI\)-Tax-Statistics#2](http://www.irs.gov/uac/SOI-Tax-Stats---Exempt-Organizations'-Unrelated-Business-Income-(UBI)-Tax-Statistics#2)>.

**NEW ZEALAND'S RECENTLY NEGOTIATED DOUBLE TAX AGREEMENTS  
AND INTERNATIONAL TAX POLICY REFORM**

ANDREW M C SMITH\*

**ABSTRACT**

Since 2007 New Zealand has negotiated five bilateral treaties dealing with international double taxation all of which contain new provisions not found in New Zealand's earlier DTAs. In this article these treaties are reviewed and analysed with emphasis on the consequential effects for New Zealand's domestic and international tax policies. The changes brought about by these five new treaties provide further evidence that as its DTA network continues to evolve and grow, New Zealand has been increasingly forced to adopt international tax norms (as defined by the OECD Model Agreement) and to concede tax policies and rules that depart from those norms.

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## I INTRODUCTION

In common with most OECD countries, New Zealand maintains an active DTA negotiation programme. Since 2007, New Zealand has negotiated five new treaties to relieve international double taxation and eliminate fiscal avoidance and evasion.<sup>1</sup> Four of these are new DTAs — two replacing earlier DTAs with Australia and Singapore, while the remaining two are DTAs with Turkey and Hong Kong, being jurisdictions with which New Zealand has not previously negotiated DTAs. The last of these treaties is a major protocol which revises an existing DTA with the United States.

The objective of this article is to review and analyse these five new treaties and their consequential effects on New Zealand's international tax policies. The analysis in this article shows that a number of provisions in these five new treaties herald significant shifts in New Zealand's DTA policy, with flow on effects to its international tax rules found in its domestic law. The analysis will also show that these changes in DTA and international tax policies mean that New Zealand has effectively revised its position with respect to certain matters in the OECD Model Agreement<sup>2</sup> and conceded certain key policy positions it has sought to maintain in earlier DTA negotiations.

## II KEY FEATURES OF NEW ZEALAND'S DTA POLICY

Like all OECD members, New Zealand conforms with OECD directives and uses the OECD Model Agreement as a basis for its DTA negotiations, departing from the provisions of that Model in areas where it or the other contracting state have decided to adopt policies that are at variance with the Model. Commonly these are in respect of matters which have been entered as reservations and observations to the OECD Model by member states.

New Zealand's key reservations to the OECD Model Agreement can be summarised as follows:

- The business of insurance to not fall within the business profits article (Article 7) but to remain taxable according to the domestic law of each contracting state.<sup>3</sup> This permits a contracting state to tax a non-resident insurer in the absence of a permanent establishment.
- A construction project to constitute a permanent establishment if the project lasts for more than six months rather than the usual twelve months.<sup>4</sup>

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<sup>1</sup> The analysis in this article is current to 1 April 2012. Since this date, New Zealand has negotiated a new DTA with Canada, replacing an earlier one negotiated in 1980. This new Canadian DTA has not been included in the analysis in this article.

<sup>2</sup> Organisation for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital*, (OECD, Condensed Edition, July 2010).

<sup>3</sup> Reservation entered to pre-2010 version of Article 7: Ibid 172, Commentary to Article 7 para 75,.

<sup>4</sup> Ibid 126, Commentary to Article 5 para 57.

- To retain the right to tax royalties sourced from New Zealand (usually to a maximum of 10%).<sup>5</sup>
- For any payments for the use of scientific, industrial or commercial equipment to fall within the royalty article rather than the business profits article allowing the source state to impose tax within specified limits in the absence of a permanent establishment.<sup>6</sup>
- To reserve its position on the inclusion of other Income<sup>7</sup> and non-discrimination articles in any DTA it negotiates.<sup>8</sup>

Other reservations which New Zealand has entered include ones to Articles 5 and 6 to protect New Zealand's right to tax natural resource exploitation,<sup>9</sup> and one to Article 8 to protect its rights to tax domestic (cabotage) traffic carried by non-resident airlines and shipping companies.<sup>10</sup> Although no longer featured as a reservation to the current version OECD Model, New Zealand had entered a reservation to Article 10 in earlier versions of the OECD Model to retain the right to tax all dividends a maximum of 15% without a lower rate for parent-subsidiary dividends.

New Zealand's success at maintaining these positions in its DTA negotiations has been variable. With respect to some of these matters, it has been willing to make concessions. For example, only some of New Zealand's DTAs contain provisions for a construction project to constitute a PE after 6 months, while others following the OECD Model with a 12 month period. Similarly, its reserved position on the inclusion of other income and non-discrimination has sometimes been upheld by their omission while in other cases such articles have been included but with provisions widely departing from the corresponding articles in the OECD Model.<sup>11</sup> The retention of equipment leasing within the scope of the royalty article has not been consistently achieved,<sup>12</sup> while the right to tax non-resident insurers under its domestic rules has been more widely maintained, with one notable exception.<sup>13</sup>

Its greatest consistency in its departures from the provisions of the OECD Model has been in the area the withholding tax rates applying to non-resident passive income such

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<sup>5</sup> Ibid 235, Commentary to art 12 para 35.

<sup>6</sup> Ibid 236, Commentary to art 12 para 42.

<sup>7</sup> Ibid 302, Commentary to art 21 para 13.

<sup>8</sup> Ibid 352, Commentary to art 24 para 85.

<sup>9</sup> Ibid 126, Commentary to art 5 para 53 and Ibid 129, Commentary to Article 6 para 9 respectively.

<sup>10</sup> Ibid 179, Commentary to art 8 para 31.

<sup>11</sup> Refer Smith, Andrew M C and Sawyer, Adrian J, 'Chapter 23' in Michael Lang, Pasquale Pistone, Josef Schuch and Claus Staringer eds, *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) 760-3. Many of the non-discrimination articles appearing in New Zealand's DTAs in the equivalent of para (5) prohibit discrimination only vis-a-vis third countries, rather than between New Zealand and the other contracting state.

<sup>12</sup> Although most of New Zealand's DTAs include equipment leasing in the definition of a royalty for treaty purposes, a number of them include protocols which subsequently shift equipment leasing to art 7 (business profits), which means that non-resident lessors cannot be taxed in the absence of a PE. Refer First Protocol, New Zealand-Republic of Korea DTA, para 5

<sup>13</sup> Being the DTA with Switzerland.

as dividends and royalties. Archival records show that disagreements over withholding tax<sup>14</sup> rates on interest and dividends have been prominent in some DTA negotiations.<sup>15</sup> These disagreements can also be evidenced by the large number of its DTAs which have protocols appended at the time they were negotiated containing 'most-favoured nation' clauses for any future reductions in withholding tax rates.<sup>16</sup>

### III ANALYSIS OF THE FIVE NEW TREATIES

#### *A Protocol to the United States DTA 1983*

The first of the five treaties reviewed in this article is a major protocol signed with the United States on 1 December 2008 to amend the 1983 DTA with that country.<sup>17</sup> This protocol is notable for both its length (almost the same length as a standalone DTA) and the extent of the amendments it makes to the existing 1983 US DTA, which are almost equivalent to the negotiation of a completely new DTA. The negotiation of this protocol is seen as a major achievement for New Zealand after many years of seeking renegotiation of its US DTA. New Zealand felt disadvantaged in its dealings with the United States after Australia renegotiated its US DTA in 2002 and since then has been keen to commence negotiations with the US authorities to obtain similar changes to those Australia obtained in 2002. The conclusion of the protocol is also seen in New Zealand as evidence of its improving relationship and ties with the United States after its defence relationship with the country broke down in the mid-1980s.

The effect of this new protocol is that existing 1983 US DTA is updated in a number of areas. For example, the relationship of the DTA with the General Agreement on Trade in Services is clarified, along with the status of entities such as pension funds and non-profit organisations as well as how trusts and 'fiscally-transparent' entities stand under a number of the existing articles.

Six articles have been completely replaced with revised versions:

- Article 10: Dividends
- Article 11: Interest
- Article 12: Royalties
- Article 16: Limitation of Benefits
- Article 23: Non-discrimination
- Article 25: Exchange of Information

In addition, the existing Article 14 applying to independent personal services has now been deleted, reflecting the deletion of that Article from the OECD Model in 2000, leaving such services to fall within the scope of Article 7 concerning business profits.

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<sup>14</sup> Known as Non-Resident Withholding Tax (NRWT) in the *Income Tax Act 2007*.

<sup>15</sup> Refer Smith, A M C; 'A History of New Zealand's Double Tax Agreements' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 105, 111.

<sup>16</sup> Such clauses are found in protocols attached to New Zealand's DTAs with Austria, Chile, Finland, Italy, Korea, Mexico, Norway, Spain, Switzerland, Taiwan, and the United States.

<sup>17</sup> For a more detailed analysis of the US protocol refer: Smith, A M C; 'New Protocol to the 1982 New Zealand-United States Tax Treaty' (2009) 63 *Bulletin for International Taxation* 289.

## 1 Article 10: Dividends

The new Article 10 brings about considerable changes to the taxation of dividends. While the 15% withholding tax rate is retained for portfolio dividends, when the shareholder is a company that owns at least 10% of the voting interest in the other company, the withholding tax rate is reduced to a maximum of 5%. Where the beneficial owner of the shares is a company that has directly or indirectly at least 80% of the voting power in the company paying the dividend, the dividend is subject to a 0% rate<sup>18</sup> in the source country.<sup>19</sup> Eligibility for this 0% rate, however, is subject to two further conditions:

- The 80% or greater beneficial ownership test must be met for at least 12 months prior to the relevant dividend being paid; and
- The provisions in Article 16 on the limitation of benefits applying to companies must also be met.<sup>20</sup>

This new dividend article also covers the status of distributions to New Zealand residents by U.S. Regulated Investment Companies ('RICs') or U.S. Real Estate Investment Trusts ('REITs').<sup>21</sup> Dividends paid by a RIC can be taxed in the U.S. to a maximum of 15%. In the case of dividends paid by a REIT, the 15% limit applies only if:

- The beneficial owner of the dividends is an individual or a pension fund with an interest not exceeding 10% in the REIT; or
- The dividends are paid with respect to a class of stock which is publicly traded and the beneficial owner of the dividends is a person that has an interest not exceeding 5% of any class of the REIT's stock; or
- The beneficial owner of the dividends is a person holding an interest of not more than 10% in the REIT and the REIT is diversified.<sup>22</sup>

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<sup>18</sup> This is the terminology used in both Subpart RF of the *Income Tax Act 2007* and the relevant DTAs. Why this terminology has been adopted instead of the word 'exempt' is not clear.

<sup>19</sup> Article 10(3) as amended by the Protocol.

<sup>20</sup> This is that the principal class of shares in the company holding the 80% or more beneficial ownership must be regularly traded on one or more recognised stock exchanges, one of which is located in the contracting state where the company is resident or the state where the company's primary place of management and control is based, with corresponding provisions for any interposed companies. In the case of pension funds, more than 50% of the entities' beneficiaries must be resident in either contracting state. In the case of closely-held companies, for at least half the days of the taxable year at least 50% of a company's aggregate voting power and value must be held by residents of a contracting state, subject to further anti-avoidance provisions in respect of disbursements made by that person in respect of that shareholding.

<sup>21</sup> Article 10(4) as amended by the Protocol.

<sup>22</sup> For the purposes of the protocol, a REIT is 'diversified' if the value of any single interest does not exceed 10% of its total interests in real property. There is a look-through rule for partnerships in determining if a REIT has real estate interests held through a partnership.

## 2 Article 11: Interest

While the 10% withholding tax rate for interest is retained in the revised Article 11, the list of exemptions is expanded. The most significant of the new exemptions is for interest beneficially owned by a resident of either state which is a bank or 'enterprise substantially deriving its gross income from the active and regular conduct of a *lending or finance business* involving transactions with unrelated parties' (author's emphasis), provided the interest to which the exemption is being applied is paid between non-associated parties.<sup>23</sup>

The term 'lending or finance business' is defined<sup>24</sup> to include not only the making of loans but also:

- Purchasing or discounting of accounts receivable notes or instalment obligations (ie factoring);
- Lease financing (including the entering of finance leases and purchasing, servicing, and disposing of finance assets and related leased assets);
- Issuing letters of credit or providing guarantees; or
- Providing charge and credit card services.

If any interest is sourced from New Zealand, to be eligible for the above exemption the New Zealand borrower must have also paid the 'Approved Issuer Levy' ('AIL') in respect of that interest.<sup>25</sup> If any interest sourced from New Zealand has not been subject to AIL, New Zealand has the right to deduct withholding tax up to 10%. Furthermore, if the payment of interest in any of the situations listed above is part of 'an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect as back-to-back loans' then New Zealand still reserves the right to impose NRWT up to 10%.<sup>26</sup>

The inclusion of 'lease financing' here is notable because it is the first New Zealand DTA where leasing is mentioned in the interest article. Most of New Zealand's DTAs do not include specific references to finance leases in their interest articles and this sometimes results in uncertainty as to which article applies to a cross-border finance lease. The inclusion here of leasing represents a significant change to the tax treatment of finance leases under the US DTA as the 1983 US DTA originally provided for the leasing of scientific, industrial and commercial equipment to fall within the scope of the royalty article, enabling the source state to impose tax at a rate up to 10% of the gross amount of the payments. This new wording now means that finance leases can be exempt in the

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<sup>23</sup> Article 11(3)(c) as amended by the Protocol.

<sup>24</sup> Article 11(3) as amended by the Protocol.

<sup>25</sup> AIL is a tax imposed upon New Zealand *borrowers* (not the non-resident lenders) of 2% in respect of interest paid to non-residents under the *Stamp and Cheque Duties Act 1971*. Interest upon which AIL has been imposed is exempt from non-resident withholding tax (NRWT) in New Zealand.

<sup>26</sup> Article 11(10)(b) as amended by the Protocol.



source state. It complements changes made to the taxation of operating leases which are discussed in the next section.

### 3 *Article 12: Royalties*

The revised royalty article contains two major changes from the earlier version of this article negotiated in 1983. The rate of withholding tax that can be imposed in the source state on royalties cannot exceed 5% (instead of the 10% prevailing in the original DTA). This is the first New Zealand DTA with a royalty withholding tax rate below 10%.

Secondly, the leasing of industrial, commercial and scientific equipment (including assets acquired by way of hire purchase arrangements) has been removed from the definition of 'royalty' article. Such leases now fall within the interest article for finance leases (as mentioned earlier) or in the case of operating leases, the business profits article (Article 7). Until this protocol was negotiated, virtually all of New Zealand's DTAs have included equipment leasing within the royalty article, although a number do not ultimately follow through with this treatment due to appending protocols which subsequently modify the tax treatment of equipment leasing by bringing it within the business profits article, which means that New Zealand cannot tax a non-resident lessor unless it has a permanent establishment in New Zealand.<sup>27</sup> Such modification to the tax treatment of equipment leasing in this way has often resulted in uncertainty as to whether finance leases are to be taxed under Article 7 (Business Profits) or whether they can still fall within Article 11 (Interest), given the presence in the equivalent of Article 11(3) of wording that interest includes 'any income treated as income from money lent by the laws, relating to tax, of the Contracting State in which the income arises'.<sup>28</sup> Thus the revisions here to the royalty and interest articles arising from the US protocol give much greater clarity to the taxation of cross-border leases, both operating and finance.

### 4 *Article 16: Limitation of Benefits*

While the 1983 DTA does contain a limitation of benefits article, it has been replaced with a revised version under the protocol. The new article introduces different criteria for eligibility to claim benefits under the DTA. In the case of a corporation, the 1983 DTA required that more than 75% of the number of shares be held by a *combination* of U.S. residents and/or citizens and New Zealand-resident individuals. This combination test has been replaced in the new Article 16 with a shareholder test based upon the residency of one contracting state (not both) with limits set at 50% or greater instead of the earlier 75%. A similar 50% test is introduced for pension funds and non-profit entities. Permanent establishments will in some situations be able to claim DTA benefits

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<sup>27</sup> This shifting of equipment leasing to Article 7 arises under the Belgium, France, Germany, Korea and Netherlands DTAs.

<sup>28</sup> Under two of New Zealand's existing DTAs (France and Korea), there is considerable uncertainty as to which article a finance lease falls within as both treaties were negotiated before New Zealand introduced domestic law rules in 1982 for finance leases. The uncertainty arises because both interest articles have a definition of interest with an assimilation clause for interest as defined by the laws of the source state which in these cases has been significantly changed after these DTAs were concluded.

even though the taxpayer may not qualify for benefits under earlier criteria, again a new feature. There is a carryover from the 1983 version of the article for persons who are otherwise ineligible to claim benefits under the DTA to obtain benefits in respect of a specific item of income if the competent authority determines that the 'establishment, acquisition or maintenance of such a person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits' under the DTA (ie treaty shopping). Most of New Zealand's other DTAs contain no equivalent provision.<sup>29</sup>

#### 5 *Articles 23 and 25 Covering Non-Discrimination and Exchange of Information*

Both of these existing Articles in the 1983 US DTA have been replaced with revised ones. The new non-discrimination article contains updated wording while the new exchange of information article is considerably more detailed, reflecting the revised wording of the 2008 OECD Model Convention.

### **B Revised DTA with Australia**

Negotiations for this new DTA with Australia to replace the earlier 1995 one were concluded on 26 June 2009. The background to the negotiation of this new DTA is notable because the New Zealand Inland Revenue Department publicly solicited submissions prior to commencing negotiations — the first time this had occurred in New Zealand. This request for public input reflects the extensive economic ties that have evolved between the two countries as result of the Closer Economic Relations agreement<sup>30</sup> negotiated in 1983 and the consequential relevance of the Australian DTA to many New Zealand taxpayers. The conclusion of this revised DTA was given some urgency after the conclusion of the US protocol so that New Zealand's Australian DTA would contain comparable provisions to those that had been negotiated with the US.

The key changes arising from this new DTA include:<sup>31</sup>

- Revised limits on withholding taxes on passive income;
- Provisions for 'fiscally transparent' entities;
- Revised definition of permanent establishment;
- Revised arrangements for dependent services;
- Pension taxation;
- Inclusion of non-discrimination article.

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<sup>29</sup> Some New Zealand DTAs (China, Fiji, India, Korea, Malaysia, Singapore) contain an unusual provision to limit specific benefits arising from tax sparing granted under these DTAs. These limitation of tax sparing benefit provisions appear either by way of Protocol or in the treaty itself and allow New Zealand to deny the benefits of tax sparing to parties from third countries after consultations between the New Zealand Inland Revenue Department and corresponding revenue authority.

<sup>30</sup> *Australia New Zealand Closer Economic Relations Trade Agreement* (ANZCERTA) signed 28 March 1983 in Canberra. This Agreement replaced the New Zealand Australia Free Trade Agreement signed in 1965.

<sup>31</sup> For a more detailed analysis of the new Australian DTA refer: Quintal, A and G Mills, 'New trends in New Zealand's Double Tax Agreements' [2010] 5 *New Zealand Tax Planning Reports* 1.

## 1 *Revised Limits for Withholding Taxes on Passive Income*

Article 10 in this new DTA contains revised withholding tax rates applying to dividends comparable to those in US protocol. The 15% rate for portfolio dividends remains, but a 5% rate is introduced for shareholdings of 10% or more, which is consistent with the OECD Model Agreement. In addition there is a 0% rate if the beneficial voting interest in the company is 80% or more for at least 12 months prior to the declaration of the dividend and the beneficial owner of the dividends is a company which is:

- listed and has its principal class of shares regularly traded on a recognised stock exchange (as specified in Article 3);<sup>32</sup> or
- owned directly or indirectly by companies listed on recognised stock exchanges listed in Article 3, or by companies which would be eligible for similar benefits under a DTA with a third country; or
- if neither of the above two conditions are met, one in respect of which the competent authority of the source state is satisfied that the dividends are not being paid deliberately as part of an arrangement to exploit this exemption, as specified in paragraph 9 of the Article.

Thus, for 80% or greater holdings the conditions for the 0% rate are not directly comparable to the conditions for the 0% rate in the US protocol. An exemption is also provided for all dividends paid to a contracting state, political subdivision or local authority including sovereign wealth funds.<sup>33</sup>

Interest remains taxable at a maximum of 10% under this new DTA; however, a 0% rate is specified for interest paid to third party banks and some government bodies.<sup>34</sup> In common with the US treaty, for any New Zealand-sourced interest to be eligible for this 0% rate, the New Zealand borrower must have paid the Approved Issuer Levy in respect of that interest. If this Levy is not paid, New Zealand has the right to deduct withholding tax up to 10%. In addition, if any interest paid is part of 'an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect as back-to-back loans' it is not eligible for the 0% rate and New Zealand can still deduct withholding tax up to 10%.

In common with the revised US DTA, the withholding tax rate for royalties has been reduced to 5%. Another significant change is that equipment leasing no longer falls within the definition of royalties for treaty purposes, which means that a non-resident lessor cannot be taxed in a contracting state in respect of an operating lease unless they are carrying on business through a PE there. Finance leases remain within the scope of the interest article due to the assimilation clause in the definition of interest in paragraph (5) in that article.

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<sup>32</sup> Being the Australian and New Zealand exchanges as well as any other stock exchange which the two competent authorities agree to.

<sup>33</sup> Article 10(4). Relevant sovereign funds would be the Australian Future Fund and the New Zealand Superannuation Fund.

<sup>34</sup> Article 11(3).

## 2 *Fiscally Transparent Entities*

A paragraph has been included in Article 1 to confirm that income derived by a person through a fiscally transparent entity (such as a limited partnership) under the laws of either state is to be treated as derived by a resident of that state if the income is so treated under the domestic law of the state where the person is resident.<sup>35</sup> This addresses a problem that can arise with Australian limited partnerships where they are taxed as companies in Australia but treated as fiscally transparent in New Zealand.

## 3 *Definition of Permanent Establishment and Independent Services*

This new DTA contains a significantly revised PE definition in Article 5 incorporating special provisions for personal services, which follows the option outlined in paragraph 42.23 of the Commentaries to Article 5 of the OECD Model for independent personal services. These provisions apply to activities that were previously within the scope of the former Article 14 prior to its deletion from the OECD Model in 2000. Under Article 5(4) of the new Australian DTA, a PE arises if a taxpayer performs services in a contracting state for more than 183 days in any 12 month period and more than 50% of the gross revenues attributable to the active business of the enterprise are attributable to those activities. A PE also arises if such services are provided for more than 183 days in any 12 month period for the same or connected project through one or more individuals being present in the state.<sup>36</sup> In applying this second limb, visits not exceeding 5 days are not taken into account unless the services are performed by that individual on a regular basis.<sup>37</sup> These rules for cross-border services were unique among New Zealand's DTAs (they were subsequently followed in the new Hong Kong DTA reviewed later in this article) and are appropriate given the extent of the trade in services between the two countries as they provide an efficient and convenient basis for taxing such services.

A PE also arises from activities connected with natural resource exploitation if they exceed 90 days in any 12 month period.<sup>38</sup> The operation of substantial equipment in a state also creates a PE if its operation exceeds 183 days in any 12 month period.<sup>39</sup> In earlier DTAs there was no time limit specified for such activities.

## 4 *Dependent Services*

Reflecting the tenor of the provisions for independent personal services above, there is a new provision in Article 14(4) (Income from Employment) applying to short-term secondments. The income from such secondments would normally be taxable in the state where the work was performed because the employer is either resident or has a PE there. However, under this new DTA if such secondments do not exceed 90 days in any

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<sup>35</sup> Article 1(2).

<sup>36</sup> Article 5(4)(a)(ii).

<sup>37</sup> Article 5(5). This five day exclusionary rule does not appear in the Commentaries to the OECD Model and appears unique to the Australian-New Zealand DTA.

<sup>38</sup> Article 5(4)(b).

<sup>39</sup> Article 5(4)(c).

12 month period then the employee remains taxable in respect of their employment income only in the contracting state where they are usually based.

## 5 Pensions

Both New Zealand and Australia have adopted domestic tax rules for superannuation (pension) schemes whereby benefits paid from approved schemes are exempt from tax in members' hands. The new Australian DTA contains a revised pension article which extends this tax exemption when pensions are paid between the two countries.<sup>40</sup> This mutual exemption is a departure from the usual tax treatment of pensions in the OECD Model.<sup>41</sup> The revised pension article however, allows New Zealand to tax offshore payments (known as 'portable payments') of New Zealand Superannuation although it currently does not do so under domestic law.<sup>42</sup>

Foreign taxation of New Zealand pensions paid offshore has often disadvantaged New Zealanders pensioners living overseas as the New Zealand domestic exemption for pension payments is not usually recognised overseas, which results in further taxation without any foreign tax credit being available as they were exempt in New Zealand. While these revised pension tax rules in the Australia DTA will be welcomed by affected persons, it has only been possible to negotiate this mutual recognition of exempt pensions because both countries provide for exempt pensions in their domestic law. Additionally, New Zealand sees these arrangements as unique in the context of the open market with Australia and the free movement of labour between the countries. A New Zealand public official has indicated to the author that New Zealand will otherwise continue to adhere to the position in the OECD Model that pensions are taxable only in the residence state and it will not seek similar exemptions for its pensions in other DTA negotiations.

## 6 Non-Discrimination Article

Despite four comprehensive DTAs being negotiated with Australia since 1960, only this latest one includes a non-discrimination article.<sup>43</sup> New Zealand has entered a reservation to the corresponding article in the OECD Model and approximately half of its treaties do not include one, which is also the case for many DTAs negotiated by Australia.<sup>44</sup>

The non-discrimination article included in this treaty follows the OECD Model in key paragraphs. In particular it has adopted the equivalent of Article 24(5) from the OECD Model, concerning permanent establishments. Many non-discrimination articles found

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<sup>40</sup> Article 18(1).

<sup>41</sup> This treatment is discussed as an option in the Commentary to Article 18: OECD, *Model Tax Convention on Income and on Capital*, above n 2, 281–2 paras 22–23.

<sup>42</sup> Exempt under *Income Tax Act 2007* ss CW 28(1)(c), (d).

<sup>43</sup> Article 24.

<sup>44</sup> Refer C J Taylor, 'Some distinctive features of Australian tax treaty practice: An examination of their origins and interpretation' (2011) 9 *eJournal of Tax Research* 294, 324.

in New Zealand DTAs contain a significantly modified version of Article 24(5), which only outlaws discrimination vis-a-vis third states for permanent establishments.<sup>45</sup>

The non-discrimination article in the Australian DTA also follows a pattern found with non-discrimination articles in other New Zealand DTAs in that it contains additional paragraphs to those found in the OECD Model. These paragraphs are designed to clarify that the non-discrimination article does not apply to anti-avoidance provisions specifically targeted at non-residents such as transfer pricing and thin capitalisation rules. The non-discrimination article in the Australian DTA goes further than most of New Zealand's DTAs in this regard by also including in Article 24(5) a list of specific provisions to which the non-discrimination article does not apply such as provisions:

- Designed to *prevent the avoidance or evasion of taxes*; (author's emphasis — the term is specifically defined further in the DTA, which is discussed below);
- Preventing the deferral of tax arising on the transfer of assets where the subsequent transfer by the transferee would take it beyond the taxing jurisdiction of the contracting state;
- Providing for the taxation of a group of companies on a consolidated basis, provided that companies resident of one state but controlled by residents from the other contracting state are treated equally;
- Providing for the transfer of company losses within a group;
- Denying rebates, credits and exemption in relation to dividends paid by a company which is resident of a state;
- Providing deductions to eligible taxpayers for research and development expenditure; and
- Subsequently added to this list of exclusions by an Exchange of Notes between the contracting states.

The phrase 'designed prevent the avoidance or evasion of taxes' is defined in 24(6) to include:

- Measures designed to address thin capitalisation, dividend stripping, and transfer pricing;
- Controlled foreign company, transferor trusts, and foreign investment fund rules; and
- Measures designed to ensure that taxes can be effectively collected and recovered.

These exclusionary provisions in Article 24(5) and (6) are the most detailed of any found in a non-discrimination article from a New Zealand DTA to date and have been subsequently carried over to the new Hong Kong DTA. These exclusions appear to reflect concerns of both Australia and New Zealand that anti-avoidance measures aimed

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<sup>45</sup> Refer Hunt, G; 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14 *New Zealand Journal of Taxation Law and Policy* 131, 166.

at non-residents could be overruled by the OECD Model non-discrimination article or that certain domestic tax rules applying to companies could create tax avoidance opportunities in a cross border situation.

### ***C Revised DTA with Singapore***

Negotiations for this new DTA were concluded on 26 August 2009, replacing one of New Zealand's oldest DTAs, which dated back to 1973 and was negotiated prior to New Zealand's accession to the OECD the same year. The 1973 Singaporean DTA was not based on the 1963 OECD Model and its replacement with a modern version based on the OECD Model was long overdue.

In most respects the new DTA follows the OECD Model closely, with the usual variations where New Zealand has entered reservations to that Model (for example, the taxation of general insurers). The key provisions in the new DTA of note include:

- Revised limits on withholding taxes on passive income;
- Definition of permanent establishment;
- Article 13: Alienation of property and other articles.

#### *1 Withholding Taxes on Passive Income*

Following the withholding tax reductions agreed to in the US protocol and the new Australian DTA, the Singaporean DTA also includes a lower rate of 5% applying to dividends paid to a company with a voting interest of 10% or more. Unlike the US and Australian treaties, there is no provision for a 0% rate if the voting interest is 80% or more. This omission, however, will be of little consequence in many instances due to domestic law changes made to New Zealand's withholding tax rates in 2010 after the US protocol was negotiated, which are explained later.

Also following the US protocol and Australian DTA, royalties are taxed at a maximum of 5%, a reduction from 15% in the 1973 DTA. Equipment leasing, however, remains within the scope of the royalty article.

The interest article in the new Singaporean DTA closely follows the OECD Model, which is a significant change from the earlier 1973 DTA where interest could be taxed at a maximum of 15% and interest paid between associated persons did not enjoy any relief under the DTA at all. The maximum rate of tax on interest is now 10% and certain payments of interest from governmental agencies are exempt. No reference to the New Zealand Approved Issuer Levy is made in this new DTA.

#### *2 Definition of Permanent Establishment*

Similarly to the new Australian DTA, the PE definition contains provisions applying to the operation of substantial equipment and also natural resource exploitation activities — both of which give rise to a PE if conducted for more than 183 days in the aggregate in any 12 month period. Similarly, a 183 day rule applies for services but unlike the Australian DTA there is no 50% gross turnover threshold.

### 3 *Article 13: Alienation of Property and Other Articles*

The 1973 Singaporean DTA did not include an alienation of property article but one is now included, as are a number of other articles that also omitted from the 1973 DTA. Interestingly for a new DTA based on the OECD Model, non-discrimination and collection of taxes articles have not been included. While New Zealand has reserved its position on the non-discrimination article in the OECD Model, it is still willing to include such articles in its DTAs, although often with modifications as have been discussed earlier. New Zealand has expressed no reservation about including tax recovery articles in its DTAs, so the omission of both these two articles may suggest objections from Singapore.

### 4 *Tax Sparing*

The 1973 Singaporean DTA was the first DTA negotiated by New Zealand which included provisions for tax sparing, protecting the benefit of Singaporean tax incentives for New Zealand investors. Surprisingly this provision has been carried over to the new DTA (despite Singapore now being considerably wealthier than New Zealand), although agreement has finally been obtained for it to be phased out in 10 years' time.<sup>46</sup> The anti-avoidance provision applying to the tax sparing obtained by special protocol in July 1993 is now incorporated into the text of the new DTA in paragraph (5).

## **D *New DTA with Turkey***

The DTA with Turkey was negotiated on 22 April 2010.<sup>47</sup> This is the first time New Zealand has negotiated a DTA with Turkey, which is also an OECD member. In most respects the new DTA follows the OECD Model closely, with the usual variations where New Zealand has entered reservations to that Model. The key provisions which are of note include:

- Limits on withholding taxes on passive income;
- Definition of permanent establishment; and
- Inclusion of an independent services article.

### 1 *Withholding Taxes on Passive Income*

Consistently with the earlier reductions to withholding tax rates on dividends, agreed to in the US protocol and the new Australian and Singaporean DTAs, the Turkish DTA includes a lower rate of 5% applying to dividends paid to a company with a voting interest of 25% or more (not the 10% threshold specified in the US, Australian, and Singaporean DTAs). In common with the Singaporean DTA, there is no provision for a 0% rate if the voting interest is 80% or more. Unusually, Turkey retains the right to tax

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<sup>46</sup> Article 21(6).

<sup>47</sup> This treaty has been recently brought into effect under *Income Tax Act 2007* s BH 1, applying from the income year beginning 1 April 2012.



branch profits of New Zealand resident at either 5% or 15%, the lower rate applying if the branch profits are exempt in New Zealand.<sup>48</sup>

The interest article, however, provides for 10% withholding tax only if the interest is paid to a bank, but otherwise the 15% rate applies to all other interest, except for certain payments of interest to Government bodies. The 15% rate for interest is high by modern standards and appears to reflect Turkish concerns about the erosion of their tax base through offshore interest payments. Royalties are taxable at a maximum of 10% and leasing is brought within the scope of the royalty article in line with most of New Zealand's earlier DTAs.

## 2 *Definition of Permanent Establishment and Personal Services*

Similarly to the new Australian and Singaporean DTAs, the PE definition includes the operation of substantial equipment and also natural resource exploitation activities – both of which give rise to a PE if conducted for more than 183 days in the aggregate in any 12 month period. Unlike the Australian and Singaporean DTAs, the Turkish DTA does not include independent personal services within the definition of a permanent establishment. The DTA has followed the OECD Model prior to its revision in 2000 and included the equivalent of the old Article 14 with a 183 day rule for such services.

The Turkish DTA has a lengthy Protocol attached to it. Among its clauses is a provision that restricts the ability of head offices to charge offshore expenses against Turkish branch profits, which appears to either reverse or substantially restrict the scope of Article 7(3) in the main body of the treaty (taken from the OECD Model) regarding the deduction of head office expenses against branch profits. Coupled with the provisions allowing extra taxes to be imposed upon Turkish branch profits in lieu of dividend withholding tax, it appears that Turkey has some concerns about tax avoidance through the use of branch structures in that country.

### **E *New DTA with Hong Kong***

The DTA with Hong Kong was negotiated on 1 December 2010 and is New Zealand's second comprehensive DTA with a quasi tax haven, the first being a DTA with the United Arab Emirates, signed in 2003.<sup>49</sup> The Hong Kong DTA has been negotiated as part of a bilateral free trade agreement negotiated between New Zealand and the territory. Hong Kong has only recently started negotiating comprehensive DTAs.<sup>50</sup> It had previously been satisfied negotiating limited scope shipping and air transport treaties, these being areas where double taxation was a particular concern for Hong Kong based enterprises,

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<sup>48</sup> Turkey has entered a reservation to Article 10 to this effect: OECD *Model Tax Convention on Income and on Capital*, above note 2, 205, Commentary to Art 10, para 5.

<sup>49</sup> This treaty has just been brought into effect under *Income Tax Act 2007* s BH 1 at the time of writing and applies for the income year beginning 1 April 2012; however some provisions apply from 1 January 2012.

<sup>50</sup> Hong Kong rapidly expanded its DTA network in 2010 and 2011, negotiating 16 DTAs in two years. Refer Vanderwolk, J, 'Hong Kong's new tax treaty network' (December 2011) 9 *eJournal of Tax Research* 247. Other OECD members that have concluded comprehensive DTAs with Hong Kong include Austria, Belgium, Czech Republic, France, Hungary, Ireland, Japan, Luxembourg, Netherlands, Portugal, Spain, Switzerland, and the United Kingdom.

given its sourced based taxation regime. The impetus to negotiate comprehensive DTAs has been driven by concerns about the competitiveness of Hong Kong as a trading and financial centre (especially vis-a-vis Singapore), blacklisting under other countries' CFC rules, and pressure for information exchange from the G-20 and OECD.<sup>51</sup>

The new Hong Kong DTA is based on the OECD Model and the key areas of departure from that Model are very similar to those in the new Australian DTA. Notable provisions in this new DTA include:

- Limits on withholding taxes on passive income;
- Definition of permanent establishment;
- Detailed non-discrimination Article.

### 1 *Withholding Taxes on Passive Income*

The standard withholding tax rate for dividends is 15%. Consistent with the earlier reductions to withholding tax rates on dividends agreed to in the US protocol and the new Australian, Singaporean, and Turkish DTAs, the Hong Kong DTA includes a lower rate of 5% applying to dividends paid to a company with a voting interest of 10% or more.<sup>52</sup> There is also provision for a 0% rate if the beneficial voting interest in the company is 50% or more and the beneficial owner of the dividends is a company that is:

- listed and has its shares regularly traded on a recognised stock exchange (as specified in Article 3);<sup>53</sup>
- owned directly or indirectly by companies listed on recognised stock exchanges listed in Article 3, or by companies which would be eligible for similar benefits under a DTA with a third country; or
- if neither of the above two conditions are met, one in respect of which the competent authority of the source state is satisfied that the dividends are not be paid deliberately as part of an arrangement to exploit this exemption as covered in paragraph 8 of the Article.<sup>54</sup>

Also in common with the Australian DTA, dividends paid to specified government institutions in both states are to be exempt from tax.<sup>55</sup> The conditions for the 0% rate are slightly different to the Australian DTA in that the voting interest threshold is 50% not 80% and there is no requirement for the voting interest threshold to be maintained at least 12 months before the dividend is declared. This DTA in fact contains the most liberal taxing provisions for cross-border dividends of any New Zealand DTA to date.

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<sup>51</sup> Refer Vandervolk *ibid* 248–9.

<sup>52</sup> Article 10(2).

<sup>53</sup> Being the Hong Kong and New Zealand exchanges as well as any other stock exchange which the two competent authorities agree to.

<sup>54</sup> Article 10(3).

<sup>55</sup> Article 10(4).

The interest article is very similar to the one included in the new Australian DTA. The basic withholding tax rate is 10%, with exemptions for interest paid to specified government bodies. Also exempt is interest paid to non-associated financial institutions; however, in New Zealand's case the exemption only applies if the interest is subject to the Approved Issuer Levy ('AIL').<sup>56</sup> Royalties in this new treaty are also taxable at 5%. But unlike the Australian DTA, equipment leasing still falls within the scope of the royalty article.

## 2 *Definition of Permanent Establishment and Personal Services*

The Hong Kong DTA includes a PE definition very similar to that found in the new Australian DTA. Apart from the similar provisions applying to natural resource exploitation and operation of substantial equipment both of which give rise to a PE if such activities carry on for more than 183 days in any 12 month period,<sup>57</sup> there are also identical provisions applying to personal services performed by one person (183 days in any 12 month period plus a 50% + gross revenue test), and services performed by more or more persons on the same or connected project (183 days in a 12 month period).<sup>58</sup>

## 3 *Other Provisions of Note*

The Hong Kong DTA contains a non-discrimination article almost identical to one in the new Australian DTA (noted earlier in section III.B.6.), which incorporates a lengthy and detailed list of provisions to which the article does not apply. The incorporation of these exclusions, identical to those in the new Australian DTA, suggests they have been included at New Zealand's request and reflect New Zealand's concern that non-discrimination undertakings could frustrate the application of its anti-avoidance provisions targeted at non-residents, or its desire to prevent tax avoidance occurring through unintended exploitation of one state's domestic company tax rules.

In common with the new Singaporean DTA, the Hong Kong DTA does not include an assistance in the collection of taxes article.

## IV SUBSEQUENT DOMESTIC LAW CHANGES

The announcement that a substantial protocol had been negotiated with the US with reduced dividend withholding tax rates had immediate implications for New Zealand domestic tax law, particularly the foreign investor tax credit ('FITC') rules.<sup>59</sup> Although no reference was made to the FITC rules at the time the protocol was announced in

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<sup>56</sup> Article 11(5).

<sup>57</sup> In the Australian DTA, the threshold for natural resource exploitation is only 90 days in any 12 month period, while substantial equipment operation is 183 days.

<sup>58</sup> Article 5(5).

<sup>59</sup> Refer A M C Smith, 'The Taxation Of Non-Resident Equity Investment In New Zealand: Unilateral Extension of Domestic Imputation Regime To Non-Resident Portfolio Investors' (1994) 48 *Bulletin for International Fiscal Documentation* 59; and A M C Smith 'Dividend Imputation and International Equity Investment: Unilateral Extension of Imputation to Non-resident Investors' (1994) 11 *Australian Tax Forum* 247.

December 2008, it was immediately recognised that these rules would have to be revised before the US protocol came into effect otherwise a windfall tax reduction would arise for US shareholders of New Zealand companies.<sup>60</sup>

There was already some evidence prior to the negotiation of the new US protocol that New Zealand officials were reconsidering the FITC rules.<sup>61</sup> In a discussion document titled *New Zealand's International Tax Review: A direction for change*,<sup>62</sup> issued as part of a comprehensive review of New Zealand's CFC rules, it was noted that while the FITC rules had resulted in lower overall New Zealand tax for non-resident investors, because New Zealand continued to levy 15% withholding tax on dividends it had been unable to obtain reciprocal reductions in foreign taxes imposed on foreign dividends paid to New Zealand investors.<sup>63</sup> This was seen as placing New Zealand at a disadvantage with Australia, especially after Australia had renegotiated its US DTA in 2002.<sup>64</sup> There were also concerns that the FITC rules may not have entirely achieved what was intended from their introduction due to high compliance costs for New Zealand companies applying the FITC rules and also to the fact that the tax reductions these rules provided were not captured in headline rates of tax and thus were often difficult for foreign investors to comprehend.<sup>65</sup>

Due to impact of the reduced dividend withholding tax rates on the FITC rules, before the US protocol was brought into effect amendments were made to the FITC rules in 2010. The FITC rules are now limited to portfolio investors who have voting interests in New Zealand resident companies of below 10% and are also conditional on their dividends being subject to non-resident withholding tax at 15% or more after any applicable DTA.<sup>66</sup> Because these changes to the FITC rules affected investors from all countries (not just the US), changes were also made to the dividend withholding tax rates where shareholders had voting interests of 10% or more. The withholding tax rates for 'fully imputed' dividends<sup>67</sup> paid to these shareholders were reduced as follows:

- For non-resident investors, with 10% or greater voting interests in a New Zealand resident company, fully imputed dividends are subject to withholding tax at 0% (ie

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<sup>60</sup> Refer Smith, Andrew M C; 'New Protocol to the New Zealand-United States Treaty' (2009) 63 *Bulletin for International Taxation* 289, 293.

<sup>61</sup> Minister of Revenue, Hon Peter Dunne, *Ministerial Media Release*, 24 August 2006.

<sup>62</sup> Hon Dr Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue, Policy Advice Division of the Inland Revenue Department, Wellington, New Zealand, December 2006.

<sup>63</sup> Paragraph 8.12, 64.

<sup>64</sup> Paragraph 8.13, 64.

<sup>65</sup> Evidence of this can be seen in the following letter to the editor of *Tax Notes International* by the author in response to an article surveying Asia Pacific company tax rates: Smith, A M C; 'Clarifying New Zealand's Dividend Withholding Tax Rates', Letters to the Editor (2005) 40 *Tax Notes International* 509.

<sup>66</sup> *Income Tax Act 2007*, s LP 2(1)(a). The FITC rules are predicated on New Zealand being able to impose withholding tax at 15% on dividends, and if any lower rate was applicable it would mean that non-resident investors would effectively pay less tax than New Zealand resident ones if there was no revision to the FITC rules.

<sup>67</sup> The formula for calculating 'fully imputed' dividends is contained in *Income Tax Act 2007*, s RF 9. Fully imputed dividends are ones that are paid out of company profits and which have borne income tax at the full company tax rate.

exempt).<sup>68</sup> This 0% rate applies whether or not the non-resident shareholder is a company, which is more liberal than the conditions specified in the three DTAs with the 0% rate where the 0% rate applies only to corporate shareholders.

- Fully imputed dividends paid to shareholders with voting interests below 10% where a DTA applies with a tax rate below 15% also attract the 0% rate.

The effect of these changes is that the withholding tax reductions for dividends in these new DTAs have been extended to all non-resident investors from whatever country, irrespective of whether they are subject to a DTA or not. Furthermore, eligibility for the 0% rate is extended to all shareholders of any kind, not limited to only corporate ones as specified in the three relevant DTAs.

## V IMPLICATIONS OF THESE NEW TREATIES FOR NEW ZEALAND'S INTERNATIONAL TAX POLICY

These five new treaties are the first to include withholding tax rates below 15% for dividends and below 10% for royalties after New Zealand for many decades insisting on these rates in all of its DTAs. Although New Zealand had effectively reduced dividend taxation for non-residents under the FITC rules introduced in 1993, this was a unilateral reduction without any reciprocal reduction for New Zealand investors offshore. The reduced rates in these new treaties now mean that New Zealand investors will enjoy reciprocal tax reductions on their foreign dividends, something that the FITC rules did not achieve.

Withholding tax rates have been a point of disagreement in many of New Zealand's DTA negotiations, reflecting tensions between a capital importing country and capital exporting ones.<sup>69</sup> As a consequence of these disagreements, many of New Zealand's DTAs contain 'most favoured nation' ('MFN') clauses in protocols appended to its DTAs, requiring it to enter negotiations 'without undue delay' with a view to reducing withholding tax rates if it subsequently negotiates another DTA with lower withholding tax rates. Until the negotiation of the US protocol in December 2008, New Zealand had been able to maintain consistent withholding tax rates in all of its DTAs and not trigger these clauses. The negotiation of these five new treaties means that New Zealand has now triggered these MFN clauses and must notify the relevant states that it is prepared to enter negotiations to revise the withholding tax rates in its existing DTAs with those states; however, no such negotiations have occurred to date.

The pressure for other countries to seek equivalent reductions in withholding tax rates has, however, been undermined by the unilateral reductions in domestic dividend withholding tax rates New Zealand made in 2010. The new DTAs reviewed in this paper, and the existing MFN obligations, could have given New Zealand some scope to quickly obtain commensurate reductions in the withholding tax rates in its other DTAs. However, the simultaneous reduction in its dividend withholding tax rates in its domestic law on more liberal criteria than specified in these five new treaties means

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<sup>68</sup> *Income Tax Act 2007*, s RF 11B(a).

<sup>69</sup> Refer Smith, A M C; 'A History of New Zealand's Double Tax Agreements' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 105, 129.

that any leverage has been effectively conceded. This is despite the earlier conclusion of New Zealand public officials that the FITC rules were deficient in not providing reciprocal reductions for New Zealand investors and that withholding tax reductions were better made in the context of bilateral tax treaties. There may, however, be some impetus to renegotiate lower withholding tax rates on royalties as the domestic rate of 15% is unchanged.

The New Zealand experience of DTA partners seeking renegotiation or amendment of existing DTAs when a MFN clause is triggered is also mixed. New Zealand has previously given MFN undertakings in respect of the inclusion of non-discrimination articles in its DTAs, a number of which have been triggered only to have less than half the countries exercise their right to enter negotiations for inclusion of such an article. This probably reflects the relative unimportance of New Zealand as a trading partner given its small size. It may also suggest that even if the domestic law tax reductions had not been made in 2010, other states may not have exercised their MFN rights very quickly.

Turning now to the practical impact of these new DTAs, and the subsequent domestic law changes on cross-border dividend taxation, the difference in the conditions for the 0% rate in these new treaties and in domestic law should be noted. Under the revised domestic law, a shareholder does not have to be a company for the 0% rate to apply, while under the new DTAs the 0% rate is limited to corporate shareholders. Secondly, the shareholding (or voting interest) thresholds for the 0% rate are not aligned between domestic law and the three new DTAs with the 0% rate. Domestic law is more generous and allows the 0% rate to apply where a 10% or greater voting interest exists, while the three DTAs specify voting interests of 80% or more in the case of Australia and the US and 50% or more with Hong Kong. The additional condition in these three DTAs that the shareholding company must also have their shares regularly traded on a recognised stock exchange will be effectively irrelevant in many cases because domestic law provides the same tax relief (ie the 0% rate) without any requirement for the shareholder to even be a company, let alone being publicly listed.

Another point of difference between the three new DTAs with the 0% rate and domestic law is that under domestic law only 'fully imputed' dividends (ie those paid out of profits that have borne company tax at the full rate) are eligible for the 0% rate, while under the US, Australian, and Hong Kong DTAs all dividends are eligible for the 0% rate whether they are fully imputed or not. This latter point is significant for distributions of capital gains which have not been taxed at the company level, a relevant issue in New Zealand since it does not comprehensively tax all capital gains. Under domestic law, untaxed capital gains distributed as dividends still attract withholding tax at 30%, but if paid to eligible corporate shareholders in the US, Australia and Hong Kong they will qualify for the 0% rate, which means that capital gains can be remitted from New Zealand without any New Zealand tax payable at either the company or shareholder levels.

At a higher level, the changes heralded under these new treaties provide further evidence that New Zealand's international tax policies are continuing to converge with OECD norms after decades of being at variance with them in a number of key areas.<sup>70</sup>

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<sup>70</sup> Ibid.

This trend towards convergence appears to have occurred because New Zealand now sees itself as both a capital exporter and importer (although an overall *net* importer) and that concessions on source taxation when reciprocally extended under a DTA will result in it collecting more tax from offshore investment by New Zealand residents. It is also final recognition that by obtaining reciprocal tax concessions for New Zealand investors and traders offshore, New Zealand will help to improve their international competitiveness. This point can also be seen in the Australian and Hong Kong DTAs with their provisions for independent personal services, which provide generous exemptions for offshore service providers in each source state.

## VI CONCLUDING COMMENTS

The five new treaties reviewed in this article are New Zealand's latest and contain major departures from what New Zealand has previously negotiated in its earlier DTAs. In particular, the withholding tax rates on dividends and royalties are lower than those prevailing in New Zealand's earlier DTAs and conform more closely to those found in the OECD Model Agreement. These reductions represent a further shift in New Zealand's international tax policy towards emphasising residence based taxation and conforming to taxing norms as found in the OECD Model.

It is disappointing that the consequential domestic law changes made to accommodate these treaties removed a lever New Zealand would have had with its other DTA partners to obtain reciprocal withholding tax reductions for New Zealand investors under the MFN clauses appended to many of its DTAs. The presence of MFN clauses in a number of its DTAs does oblige New Zealand to enter into negotiations with a number of other states for similar reductions to the rates in existing DTAs; however, the experience with MFN clauses for non-discrimination clauses suggests that many countries may not have sought those negotiations and are even less likely to do so after these unilateral reductions in dividend withholding tax rates.

New Zealand maintains an ongoing DTA negotiation programme. As at January 2012, it was engaged in negotiations with Canada, Netherlands, United Kingdom, and Vietnam for new or revised DTAs.<sup>71</sup> Negotiations for protocols to revise existing DTAs with Austria, India, and Malaysia were also underway at the same date. However, New Zealand still has two old DTAs with Fiji and Japan respectively, which are not based on the OECD Model. Negotiations for a new DTA with Japan have since been concluded in June 2012, although it may not be signed until 2013.<sup>72</sup> However, there are no proposals yet to revise the Fijian DTA or negotiate a new DAT with Malaysia, which will be New Zealand's oldest and only DTAs not based on the OECD Model once the new Japanese DTA is signed.

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<sup>71</sup> Ministry of Foreign Affairs and Trade, *Treaties and International Law: International Treaties List as at July 2012*, 71. *Double Tax Agreements (DTAs)* <<http://www.mfat.govt.nz/Treaties-and-International-Law/03-Treaty-making-process/1-International-Treaties-List/16-Double-Tax-Agreements.php>>. A revised DTA with Canada was subsequently signed in May 2012.

<sup>72</sup> Hon Peter Dunne, Minister of Revenue, *NZ-Japan to update double tax agreement*, Media Statement, 29 June 2012.





## **GAARS IN AUSTRALIA AND SOUTH AFRICA: MUTUAL LESSONS**

TERESA CALVERT AND JUSTIN DABNER\*

### **ABSTRACT**

While the South African and Australian general anti-avoidance rules ('GAARs') differ in their structure and design, each is directed towards the same end. Although the South African GAAR was substantially amended in 2006 to address perceived inadequacies, there has yet to be any judicial consideration of the 'new' provision. While it is a highly prescriptive provision (at least in comparison with its Australian counterpart) considerable uncertainty as to its effectiveness remains, especially as an earlier attempt to remedy many of the same deficiencies in 1996 was spectacularly unsuccessful.

Meanwhile, after a slow start, the jurisprudence on the Australian 1981 GAAR continues to gather momentum. Although many of the application and interpretative issues have gradually been resolved, others seem insoluble.

In this paper the authors examine these two GAARs with a view to identifying if any lessons for their application and interpretation can be gathered from each other. The authors argue that, notwithstanding design differences, there are some remarkably similar issues to be resolved. Some of the Australian case law may therefore be instructive as to the approach that could be adopted in South Africa, while some of the prescriptions in the South African legislation could be of value in assisting the Australian judiciary to direct their attention to relevant considerations or, possibly more likely, could form the basis for further legislative prescriptions in the Australian GAAR.

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## I INTRODUCTION

The South African income tax legislation has contained a general anti-avoidance rule ('GAAR') since 1941, with its most recent version dating from 2006. Meanwhile, the modern Australian GAAR dates from 1981.

The comprehensive 2006 amendments to the South African GAAR were designed to address perceived inadequacies that were not adequately addressed by earlier amendments in 1996. Notwithstanding the 1996 amendments, the provision continued to be unsuccessful in countering tax avoidance activities. Interestingly, there have been no cases that have considered the effect of the 2006 revision, and considerable uncertainty as to the effect of these amendments exists. On the other hand, the legislation is much more prescriptive as to what might constitute an unacceptable tax avoidance scheme than, for example, the Australian GAAR.

While the Australian GAAR has been subject to minor amendments in the past 30 years, its essential design and framework have remained unchanged. Most of the action has been at the case law level. Again interestingly, the Australian GAAR remained untested in the courts for eight years before what has become an avalanche of cases commenced. Following a shaky start, these cases have mostly strengthened the robustness of the provision. Nevertheless, great uncertainty as to its boundaries remains, with the Australian Tax Office ('ATO') now apparently adopting the practice of adding a Part IVA assessment to any sizeable substantive issue, as if to suggest that anything done by a large enough taxpayer carries an immediate presumption that Part IVA applies.<sup>1</sup>

This paper considers whether any guidance as to the application of the respective GAARs can be gleaned from the experience in the other country. In particular, it will examine whether the Australian case law might provide any indication as to how the post-2006 South African GAAR will be interpreted. This case law may be of particular significance given that the 2005 discussion paper, which preceded the 2006 amendments, made specific reference to the Australian experience. Furthermore, the prescriptive elements now expressed in the South African GAAR might be of some assistance in shedding light on when an Australian arrangement might fail that country's GAAR.

The paper is divided into six sections. In Section II, the background of the South African GAAR is outlined, to identify the inadequacies in the legislation that the 2006 amendments sought to remedy. The new prescriptive elements of the GAAR are detailed. This leads into Section III, in which the interpretative issues arising from the new legislation are explored. The Australian GAAR is introduced in Section IV, focusing on the primary features associated with its application that have been highlighted by the cases. Section V explores how the cases have dealt with these issues. In Section VI, the penultimate section of the paper, the authors postulate what the Australian experience could mean for the interpretation of the South African GAAR and to what extent the

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<sup>1</sup> Cooper, GS, 'Predicting the Past — The Problem of Finding a Counterfactual in Part IVA' (2011) 40(3) *Australian Tax Review* 185–200.

prescriptive elements of the South African GAAR could be of value in providing some guidance as to the future application of the GAAR in Australia. Section VII concludes that, notwithstanding the differences in the design of the GAARs in the two countries their application requires the respective courts to focus on similar factual elements.

## II THE DEVELOPMENT OF THE SOUTH AFRICAN GAAR

The South African GAAR has been amended several times since its incorporation into the South African legislation in 1941. Before the 2006 amendments, it was contained in s 103 of the *Income Tax Act 1962* ('ITA'). In that form, it included four key requirements:

- a transaction, operation, or scheme;
- that resulted in the avoidance, reduction, or postponement of tax;
- entered into or carried out in a manner not normally employed for business purposes, other than obtaining a tax benefit (the *abnormality requirement*); and
- the transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit (the *purpose requirement*).<sup>2</sup>

### A The 2005 Discussion Paper

In 1995, the Katz Commission had reported on the inadequacies of s 103 and had made recommendations for its amendment.<sup>3</sup> Unfortunately, the resultant changes failed to adequately address the limitations of the provisions, with the South African Minister of Finance stating in 2005 that 'What we can't accommodate is a rule which is intended to limit avoidance that is so abused and tatty with wear.'<sup>4</sup> Shortly after this statement, the South African Revenue Service ('SARS') released a discussion paper on s 103,<sup>5</sup> in which it highlighted the primary weaknesses of the GAAR. These weaknesses were classified under four main categories and are summarised below:

- *Not an effective deterrent*: The aggressive and increasingly sophisticated schemes entered into by taxpayers, often marketed by boutique financial institutions, had resulted in the exploitation of the GAAR. In addition to this, the significant commitment of time and resources to detecting and combating these schemes had proven to be costly, and lengthy battles over these schemes had had a negative impact on the relationship between the SARS and taxpayers.<sup>6</sup>

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<sup>2</sup> *Income Tax Act 1962* (SA) s 103(1).

<sup>3</sup> Katz, M, *Third Interim Report of the Commission into certain aspects of the Tax Structure of South Africa*, (1995).

<sup>4</sup> Engel, K (Chief Director, Tax Legislation – National Treasury), *The GAAR proposal: A National Treasury Perspective*, (2005) Slide 3.

<sup>5</sup> South African Revenue Service, *Discussion Paper on Tax Avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* (2005) ('the 2005 Discussion Paper').

<sup>6</sup> *Ibid* 41–42.

- *Abnormality requirement:* Two fundamental weaknesses of the abnormality requirement were identified both before and after the 1996 amendments to the GAAR. The first of these weaknesses stemmed from the realisation that transactions entered into *bona fide* were often hijacked or replicated by scheme promoters for the purposes of impermissible tax avoidance.<sup>7</sup> The second weakness was closely related because promoters of these schemes found it relatively easy to manufacture a plausible sounding business purpose.<sup>8</sup>
- *Purpose requirement:* The problems identified within the abnormality requirement were compounded by the existence of the purpose requirement as it left the Commissioner in the difficult position of having to disprove a taxpayer's assertion that the predominant purpose of entering into the transaction was not to obtain a tax benefit. This weakness was often abused by taxpayers in light of *CIR v Conhage (Pty) Ltd* 1999 (the *Conhage case*),<sup>9</sup> where the raising of capital for an overall commercial transaction was sufficient to inoculate each step in the larger scheme.<sup>10</sup>
- *Procedural and administrative issues:* Two main concerns were identified, as follows:
  - Uncertainty about the extent to which the GAAR could be applied to individual steps within a larger transaction.<sup>11</sup>
  - Uncertainty as to whether the Commissioner had authority to apply the GAAR in the alternative where another provision was also in dispute.<sup>12</sup>

As observed above, many of these weaknesses were identified both before and after the 1996 amendments to GAAR, and though the legislator attempted to address some of these criticisms in 1996, the amendments did not achieve their purpose. For example, the Katz Commission had suggested that the abnormality test, in the context of business dealings, should be amended to include a bona fide business purpose test, as opposed to a normality test. The amendments did include the words 'bona fide business purposes' but the word 'normal' was still left intact, which again aided in rendering the GAAR an ineffective deterrent to tax avoidance.<sup>13</sup>

In addition to the above, another weakness had been recognised because both the abnormality and purpose requirements needed to be present before a scheme could

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<sup>7</sup> This weakness was identified by the *Katz Commission* and the subsequent proposals suggested that the GAAR should be amended to make it clear that if a particular form of transaction was commercially acceptable due to the fact that it was widely used, this did not mean that the abnormality test was passed.

<sup>8</sup> South African Revenue Service, above n 5, 42–43.

<sup>9</sup> *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA), 61 SATC 391.

<sup>10</sup> South African Revenue Service, above n 5, 43.

<sup>11</sup> See *CIR v Louw* 1983 (3) SA 551 (A), 45 SATC 113.

<sup>12</sup> South African Revenue Service, above n 5, 44.

<sup>13</sup> *Ibid*, 39; Olivier, L, 'Tax Avoidance: Options available to the Commissioner for Inland Revenue' (1997) 4 *Journal of South African Law* 742; Werksmans, T, 'New General anti-avoidance rule in the works' (2006) *International Tax Review* 1; Williams, RC, 'The 1996 amendments to the general anti-avoidance section of the Income Tax Act' (1997) 114(4) *The South African Law Journal* 677.

successfully be attacked. This meant that a taxpayer could, with impunity, enter into a transaction with the (subjective) sole purpose of avoiding tax, provided that there was no (objective) abnormality in the means or manner, or in the rights and obligations which it created. Conversely, a taxpayer could, with impunity, enter into a transaction which was objectively 'abnormal', provided that he/she did not have the sole or main purpose of tax avoidance.<sup>14</sup>

### **B The 2006 GAAR**

Subsequent to the release of the 2005 discussion paper, the GAAR was significantly amended in 2006 in an effort to address these weaknesses. The provisions of the South African GAAR, incorporating those amendments, are now contained in Part IIA of the *Income Tax Act 1962*. Section 80A is the operative section and identifies the features of an impermissible tax avoidance arrangement as follows:

- there must be an arrangement;
- that results in a tax benefit;
- the sole or main purpose of which was to obtain the tax benefit; and<sup>15</sup>
  - in the context of business, the arrangement:
    - \* was carried out in a manner not normally employed for *bona fide* business purposes; or
    - \* lacks commercial substance; or
  - in a context other than business, the arrangement was carried out in a manner not normally employed for *bona fide* purposes; or
  - in any context, the arrangement:
    - \* creates rights and obligations not normally arising between parties dealing at arm's length; or
    - \* results directly or indirectly in the misuse or abuse of the provisions of the Act.<sup>16</sup>

Section 80B identifies the steps that the Commissioner may take upon concluding that an arrangement infringes the GAAR, which essentially enable the cancellation of the tax benefit. Thereafter, the part primarily contains definitional provisions. Section 80C(1) explains the term 'lack of commercial substance' as being a circumstance in which the avoidance arrangement results in a significant tax benefit but does not have a significant effect upon either the business risks or net cash flows apart from any effect attributable to the tax benefit.<sup>17</sup>

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<sup>14</sup> South African Revenue Service, above n 5, 44.

<sup>15</sup> The last requirements of the 2006-amended GAAR that indicate in which context the requirements must be applied are commonly referred to as the tainted elements.

<sup>16</sup> *Income Tax Act 1962* (SA) s 80A.

<sup>17</sup> *Ibid* s 80C.

In addition to this s 80C(2) provides a list of characteristics of avoidance arrangements that indicate a lack of commercial substance,<sup>18</sup> namely:

- the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
- the avoidance arrangement exhibits the inclusion or presence of:
  - round trip financing; or
  - an accommodating or tax-indifferent party; or
  - elements that have the effect of offsetting or cancelling each other.<sup>19</sup>

### 1 Round Trip Financing

The first indicator of a lack of commercial substance (round trip financing) is defined in *Income Tax Act 1962* s 80D and consists of three parts. The first part defines round trip financing as an avoidance arrangement where funds are transferred between or among the parties (round tripped amounts) and the transfer of the funds would result, directly or indirectly, in a tax benefit and would significantly reduce, offset, or eliminate any business risk incurred by any party in connection with the avoidance arrangement.<sup>20</sup> In order to determine whether s 80D would apply, the avoidance arrangement would have to meet all of these requirements. However, many of the terms included within this provision have not been defined and so there is some uncertainty as to their meaning.<sup>21</sup>

Furthermore, the context suggests that for the first requirement of s 80D to be met, the funding would have to be transferred between parties through some type of reciprocal action.<sup>22</sup> In addition to this, the transfer of funds would be required to directly or indirectly result in a tax benefit. Accordingly, even if the arrangement as a whole results in a tax benefit, for s 80D to apply, the transfer of funds must also directly or indirectly result in a tax benefit.<sup>23</sup> Similarly, the transfer of funds would be required significantly to reduce, offset, or eliminate the danger or chance of loss in the context of business before it would satisfy the definition of round trip financing.

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<sup>18</sup> The list of characteristics that are provided in s 80C of the *Income Tax Act 1962* (SA) is commonly referred to as the commercial substance indicators.

<sup>19</sup> *Income Tax Act 1962* (SA) s 80C.

<sup>20</sup> *Ibid* s 80D.

<sup>21</sup> Potentially problematic terms include 'between', 'among', 'significantly', 'reduce', 'offset', 'eliminate' and 'business risk'. As an example of how some of these terms may prove problematic, in using the concept of 'significant business risks', it is important to note that this concept has not been defined in the Act, nor by the courts. Its inclusion in the GAAR introduces an additional degree of subjectivity in the application of the GAAR. Introducing subjectivity to such a large degree may lead the courts to consider the ambit to be too wide and therefore 'look negatively at it which could lead to a very narrow and restricted interpretation of the statute and frustrate the fiscus': Van Schalkwyk, L and Geldenhuys, B, 'The Income Tax Act. Section 80(c)(III) of the Income Tax Act: Round-tripping between the draft version and the enacted version – part 1', (2009) *Accountancy SA* 6. In this case, it could cause destruction of the effectiveness of the current GAAR regime similar to that of its predecessor.

<sup>22</sup> De Koker, AP, *Silke on South African Income Tax*, Electronic ed. (2010) [19.7].

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

The second part of s 80D provides guidance on what circumstances should not be taken into consideration in determining whether the avoidance arrangement has the presence of round trip financing in the context of commercial substance. This part has the effect of eliminating any consideration of:

- whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;
- the timing or sequence in which round tripped amounts are transferred or received; and
- the means by, or manner in which, round tripped amounts are transferred or received.<sup>24</sup>

The third part of s 80D provides guidance as to what would constitute funds in the context of the round trip financing indicator.<sup>25</sup>

## 2 Accommodating or Tax-Indifferent Parties

The second indicator (accommodating or tax-indifferent parties) is defined in *Income Tax Act 1962* s 80E. The need to include this aspect in the GAAR was noted by SARS in the 2005 discussion paper,<sup>26</sup> where it was stated that tax-indifferent parties, by design, work to disable and defeat the balance between tax deductibility in the hands of one party and taxable income in the hands of another. Tax-indifferent parties are often aptly referred to as 'washing machines', a term that describes the roles that these parties fulfil in avoidance arrangements.<sup>27</sup> Furthermore, it was noted that 'these parties typically receive a fee (often in the form of an above-market return on investment) for the service of absorbing income or otherwise selling their tax-advantaged status to the other participants in the scheme.'<sup>28</sup>

In incorporating the concept of a tax-indifferent party into the GAAR, the law defines the main characteristics of an 'accommodating or tax-indifferent party' as follows:<sup>29</sup>

A party to an avoidance arrangement is an accommodating or tax-indifferent party if—

- a) any amount derived by the party in connection with the avoidance arrangement is either—
  - i) not subject to normal tax; or
  - ii) significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and

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<sup>24</sup> *Income Tax Act 1962* (SA) s 80D.

<sup>25</sup> *Ibid* s 80D: 'includes any cash, cash equivalents or any right or obligation to receive or pay the same.'

<sup>26</sup> South African Revenue Service, above n 5, 21.

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

<sup>28</sup> *Ibid*.

<sup>29</sup> *Income Tax Act 1962* (SA) s 80E.

- b) either—
  - i) as a direct or indirect result of the participation of that party an amount that would have—
    - aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party; or
    - bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party; or
    - cc) constituted revenue in the hands of another party would be treated as capital by that other party; or
    - dd) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or
  - ii) the participation of that party directly or indirectly involves a prepayment by any other party.

As is evident from the definition, the term ‘accommodating or tax-indifferent party’ is widely defined notwithstanding that s 80E(3) specifically excludes certain parties from being classified as such if either:<sup>30</sup>

- a) the amounts derived ... are cumulatively subject to income tax by one or more spheres of government of countries other than [South Africa] which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or
- b) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months,
  - : **Provided these** activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment ... if it were located outside the Republic and the party in question were a controlled foreign company.

This exclusion from the definition of ‘accommodating or tax-indifferent party’ thus allows ‘legitimate’ business operations to continue without risk of being considered an indicator of lack of commercial substance.

### 3 *Offsetting or Cancelling*

The last indicator (offsetting or cancelling) is not defined in the law and was introduced because if elements of a transaction have the effect of offsetting or cancelling each other it would indicate that such parts of the transaction have no real effect and were contrived for the purpose of obtaining a tax benefit (thus indicating a lack of commercial substance). Essentially, the provision is referring to ‘self-neutralising mechanisms’ and

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<sup>30</sup> Ibid s 80E(3).



draws upon precedent in the United Kingdom and other jurisdictions that gave rise to the so-called fiscal nullity doctrine.<sup>31</sup> It is targeted primarily at complex schemes, typically involving financial derivatives, which seek to exploit perceived loopholes in the law through transactions in which one leg generates a significant tax benefit while another effectively neutralises the first leg for non-tax purposes.<sup>32</sup>

In comparing the requirements of the GAAR after its amendment in 2006 with that of the amended 1996 GAAR, it is evident that the fundamental principles of the previous GAAR regime remain intact,<sup>33</sup> while additional tainted elements and commercial substance indicators have been included in the legislation. The amendments that were intended to address the weaknesses can be identified as follows:

- *Not an effective deterrent* – The inclusion of the commercial substance indicators into the GAAR were intended to address the aggressive and sophisticated schemes marketed by the boutique financial institutions after the 1996 amendments to the GAAR.
- *Abnormality requirement* – The previous abnormality test contained wording similar to that of the current abnormality element. However, the removal of the words ‘having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out’ suggests that the new abnormality requirement must be considered to be solely an objective test. It is probable, therefore, that the hijack techniques employed by promoters were the weakness that this amendment addressed.
- *Purpose requirement* – Section 80G was introduced into the GAAR and creates a presumption that the sole or main purpose of the transaction is the obtaining of a tax benefit. This amendment was introduced for the purpose of eliminating the onus upon the Commissioner of having to disprove a taxpayer’s assertion that the predominant purpose of entering into the transaction was not to obtain a tax benefit. It in essence reverses the onus of proof from the Commissioner to the taxpayer.
- *Procedural and administrative issues* – The inclusion of s 80H into the GAAR specifically addressed the uncertainty about the extent to which the GAAR could be applied to individual steps within a larger transaction. It states that ‘the Commissioner may apply the provisions of the Part to steps in, or parts of, an

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<sup>31</sup> De Koker, above n 22, [19.7].

<sup>32</sup> Ibid. The problem anticipated with the inclusion of this provision is the impact that it has on the scope of the GAAR. Typically, this provision would have the effect of including financing or hedging transactions within the scope of the GAAR, but these were never intended to be considered as ‘impermissible avoidance transactions’.

<sup>33</sup> ‘Arrangement’, as defined in the current GAAR regime, is similar to that of a transaction, operation, or scheme included in the previous GAAR regime. ‘Tax benefit’, as defined in the current GAAR regime, is similar to the avoidance, reduction, or postponement of tax, as included in the previous GAAR regime. The ‘sole or main purpose’ requirement, as included in the current GAAR regime, is similar to that of the ‘purpose’ requirement existing in the previous GAAR regime. The ‘abnormality tainted’ element included in the current GAAR regime is similar to the abnormality requirement included in the previous GAAR regime.

arrangement.<sup>34</sup> Similarly, the inclusion of s 80I into the GAAR specifically addressed the uncertainty as to whether the Commissioner had the authority to apply the GAAR in the alternative where another provision was also in dispute. It provides that 'the Commissioner may apply the provisions of the Part in the alternative for, or in addition to, any other basis for raising an assessment.'<sup>35</sup>

It is notable that no specific amendment was made to the GAAR to address the ease with which plausible sounding business purposes could be manufactured by promoters in relation to the abnormality requirement. The weakness identified in relation to the reliance on both the purpose and abnormality requirements in conjunction with each other was not attended to, with the previous structure remaining fundamentally intact, thus still requiring both of these requirements to be present before an avoidance arrangement could be successfully attacked using the GAAR.

### **III THE ELEMENTS OF THE SOUTH AFRICAN GAAR AND ONGOING INTERPRETATIVE ISSUES**

The amendments made to the GAAR in 2006 resulted in the inclusion of novel, untested legislation without a body of case law to aid in the interpretation of the new concepts. A considerable number of issues can be identified.

#### ***A Purpose Test – Subjective or Objective***

In interpreting how the 'sole or main purpose' requirement should be applied, it is noted that the legislator chose to use similar wording to that used previously. Therefore, as this requirement of the GAAR (contained in s 80A) seems largely the same as the sole or main purpose requirement of the previous GAAR regime, the findings of the South African courts in past cases should apply *mutatis mutandis* to an enquiry as to the sole or main purpose of an arrangement in terms of the current GAAR regime. The sole or main purpose requirement, thus, necessitates that a taxpayer is required to discharge their onus on the balance of probabilities to the effect that in light of the relevant facts and circumstances the obtaining of the tax benefit was not the sole or main purpose of the arrangement.<sup>36</sup>

In this investigation, the purpose of the transaction is clearly critical. While case law suggests that an enquiry into the purpose of an arrangement is a subjective one,<sup>37</sup> there is an alternative view, which some tax practitioners and academics subscribe to, that the 'sole or main purpose' test is an objective test.<sup>38</sup> In this objective test, the actual effect of a transaction should be considered, rather than the intention of the taxpayer. The existence of an objective test is possibly supported by the terms of s 80G, which effects the change in the onus of proof. This provision suggests that when applying the purpose

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<sup>34</sup> *Income Tax Act 1962* (SA) s 80H.

<sup>35</sup> *Ibid* s 80I.

<sup>36</sup> De Koker, above n 22, [19.6].

<sup>37</sup> *Secretary for Inland Revenue v Gallagher* (1978) (2) SA 463 (A).

<sup>38</sup> De Koker, above n 22, [19.6]; Meyerowitz, D, *Meyerowitz on Income Tax* (2008) 29–12; *Ovenstone v Secretary for Inland Revenue* (1980) 42 SATC 55 (A).

test, the effect of the transaction, and not just the purpose of the taxpayer, must be taken into account.<sup>39</sup>

An objective approach could provide a taxpayer with a more effective means to discharge the onus than merely relying on an assertion as to their subjective intention. On the other hand, case law<sup>40</sup> has identified that such a test could disadvantage a taxpayer, as no regard will be had to their actual intention when they entered into the transaction.<sup>41</sup> Based on the conflicting views on the interpretation of the current GAAR regime it is impossible to be certain about the manner in which it should be applied.

### ***B Commercial Substance Tests – Alternatives or Cumulative***

The commercial substance indicators listed in *Income Tax Act 1962* s 80C prove to be an additional item of concern with regards to the effectiveness of the GAAR. As explained above, s 80C identifies specific arrangements that will lack commercial substance. Although this list merely provides guidance and is not intended to limit the interpretation of the term 'lack of commercial substance',<sup>42</sup> it is uncertain as to how ss 80C(1) and (2) should be applied. In this regard it is not clear if these subsections should be regarded as separate tests or are cumulative. That is, it is unclear whether, if a transaction merely fails one of the subsections, it would result in the transaction being considered to have commercial substance. Commentators have indicated that these should be regarded as separate tests from a practical perspective but the drafting of this aspect of the GAAR has left the matter unclear.<sup>43</sup>

### ***C Round Trip Financing – 'Significant' Business Risks***

The inclusion of the round trip financing indicator within the GAAR has generated uncertainty as to how these terms will be applied by the courts. In defining the term 'round trip financing', s 80D includes the proposition that an avoidance arrangement would include round trip financing if the transfer of funds significantly reduces, offsets, or eliminates any business risk. However the concept of 'significant business risks' has not been defined within the law, nor interpreted by the courts, and may introduce uncertainty into the GAAR. The inclusion of these terms, without sufficient explanation, leaves it again impossible to be certain about the manner in which the provision would be applied.

### ***D Non-arm's Length Rights and Obligations — Relevance of Subjective Elements***

The third tainting element is focused on those arrangements where the parties have included rights and obligations within an arrangement that are not at arm's length.

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<sup>39</sup> By virtue of the reference to the need to reasonably consider 'the relevant facts and circumstances' in disproving the predominance of a tax avoidance purpose.

<sup>40</sup> *Secretary for Inland Revenue v Gallagher* (1978) (2) SA 463 (A).

<sup>41</sup> Louw, I, *The new general anti-avoidance rule: A comprehensive discourse on this statute*, Mini-Dissertation – Postgraduate Diploma: Tax Law, University of Cape Town (2007) 24.

<sup>42</sup> *Income Tax Act 1962* (SA) s 80C.

<sup>43</sup> Broomberg, EB, 'The new general anti-avoidance rule', SAFA Seminar (2007) 16.

Theoretically, the introduction of non-arm's length rights and obligations into an arrangement would indicate that the arrangement is abnormal and may have been motivated with a view to impermissible tax avoidance.

This element has been retained from the previous legislation, and it is therefore appropriate to refer to the interpretation of its predecessor by the courts. Case law suggests that the test connotes that 'each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.'<sup>44</sup> Despite the maintenance of this principle in its previous form, it is arguable that the test must now be applied using objective means as opposed to subjective means.<sup>45</sup> This change from subjective to objective was implemented in order to address the weaknesses surrounding the abnormality requirement, discussed above.<sup>46</sup> However, notwithstanding the change from subjective to objective, the 2006 amendments, similar to the 1996 amendments, have not brought about clarity as to the objective yardstick against which a transaction should be measured<sup>47</sup>. Though the words 'having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out' have been removed, commentators have noted that it remains to be asked, for example, 'what is a normal manner for *ex-partners* to incorporate their practice?'<sup>48</sup> That is, it is unclear as to what extent subjective considerations may inform the objective test.

### ***E Misuse or Abuse – Uncertainty of Meaning***

The concept 'misuse or abuse' of the Act has not been defined in the law, and would therefore have to be interpreted according to the ordinary and natural meaning of these words. When originally included in the draft version of the current GAAR regime, this provision read 'it would *frustrate* the purpose of any provision of this Act' (emphasis added). The enacted version of this section substituted the words 'misuse or abuse' for the word 'frustrate'. Though these words may be considered synonyms for each other, it is also arguable that the use of different words in the enacted version of the section must be considered in the light of the presumption that where the legislature uses a different word or expression, this has been designed to provide for a different outcome. It might be suggested that the reference to 'misuse or abuse' presupposes that there is some identifiable non-abusive use for each provision of the Act (and for the Act as a whole), which can be used as a yardstick against which to measure misuse or abuse.<sup>49</sup>

Commentators note that the inclusion of the concept of misuse or abuse is derived from the Canadian GAAR.<sup>50</sup> However, whereas the South African use of this concept is cast in

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<sup>44</sup> *Hicklin v Secretary for Inland Revenue* (1980) 1 All SA 301 (A).

<sup>45</sup> The reference to the circumstances under which the transaction was entered into has been removed, and thus arguably changes the test from subjective to objective.

<sup>46</sup> De Koker, above n 22, [19.7].

<sup>47</sup> Olivier, above n 13; Meyerowitz, above n 38, 29–11.

<sup>48</sup> Olivier, above n 13.

<sup>49</sup> Clegg, D, 'Use it or abuse it' (2007) 21 *South Africa: Tax Planning* 37.

<sup>50</sup> Mazansky, E, 'South Africa's New General Anti-Avoidance Rule — The Final GAAR' in (2007) 61(4) *Bulletin for International Taxation* 159, 162; Davis, D, Olivier, L, Urquhart, G, Ferreira, P, and Roeleveld, J, *Juta's Income Tax. Cape Town, South Africa: Juta and Company Ltd.* (2007) 80A–1; Cilliers, C, 'Thou shalt not

*Footnote continues over page*

positive language, the Canadian GAAR uses it in the negative. The Canadian GAAR thus applies the concept as a limitation on the operation of the GAAR, which arguably has the effect of preventing the GAAR from being too broad.<sup>51</sup> However, as a positive limb of the South African GAAR, the possible wide interpretation of this vague provision could plunge the current GAAR into a similar predicament that faced its predecessor when its ambit was considered to be too wide.<sup>52</sup> This may lead to instances where the courts will be left with no alternative but to chip away at the edifice of the GAAR<sup>53</sup> leading to a narrow and restricted interpretation of the statute. This could destroy the effectiveness of the current GAAR regime, as happened to its predecessor.<sup>54</sup>

It is also of note that, in defining an avoidance transaction, the Canadian legislation provides that the transaction will not be impeached if it could *reasonably* have been considered to have been undertaken for bona fide purposes other than to obtain a tax benefit.<sup>55</sup> The use of the term *reasonably* is noticeably absent from the South African version. One possible implication of this is that, while the Canadian GAAR directs the Revenue, and ultimately the courts, to adopt a fair and sensible application of the provision, the absence of such an instruction to the South African courts may result in a more strident application of the GAAR.<sup>56</sup>

There is also debate amongst Canadian commentators as to whether the misuse and abuse limb does any more than codify the purposive approach to statutory interpretation.<sup>57</sup> If not, this aspect of the South African GAAR may mark no substantive change in the law, given that the purposive approach has long received judicial support in South Africa.<sup>58</sup> This point will be taken up further in the penultimate section of the paper.

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peep at thy neighbour's wife: Section 80A(c)(ii) of the Income Tax Act and the abuse of rights' (2008) *South Africa: The Taxpayer* 86; Clegg, D and Stretch, R, *Income Tax in South Africa* (LexisNexis, Durban, 2007) [26.3.5]; De Koker, above n 22, [19.7].

<sup>51</sup> Louw, above n 41, 40.

<sup>52</sup> Van Schalkwyk and Geldenhuys, above n 21.

<sup>53</sup> Arendse, J, 'Let's talk about tax avoidance' (2006) 521(1) *Accountancy SA* 29.

<sup>54</sup> Van Schalkwyk and Geldenhuys, above n 21.

<sup>55</sup> *Income Tax Act 1985* (Canada) s 245(3).

<sup>56</sup> The word 'reasonably' is defined in the South African Concise Oxford Dictionary as a 'fair and sensible consideration'. The use of this phrasing in the context of misuse or abuse in the GAAR leads one to the conclusion that use of this term in the Canadian context requires a less severe application than the South African version, where the terms 'reasonable'; 'fair' and 'sensible' are not used: Geldenhuys, B, *An analysis of Section 80(c)(ii) of the Income Tax Act No 58 of 1962 as amended* (MAcc (Taxation) Thesis, University of Stellenbosh, 2009) 39.

<sup>57</sup> In fact, three possible approaches to this element of the Canadian GAAR have been identified, with the most likely approach to treat it as simply codifying the common law rule mandating a purposive interpretation of the tax laws: Arnold, BJ, and Wilson, JR, 'The General Anti-avoidance Rule — Parts 1, 2 & 3' (1988) 36 *Canadian Tax Journal* 831, 1123, 1369. (The views expressed in these articles are neatly summarised in Arnold, BJ, 'The Canadian general anti-avoidance rule' [1995] *British Tax Review* 541.) The leading Supreme Court decision would seem to have fulfilled this prophesy: *The Queen v. Canada Trustco Mortgage Company* [2005] SCC 54, discussed in Bernstein, J, Worndl, B, and Leung, K, 'Canadian Supreme Court's Pronouncement on GAAR: A Return to Uncertainty' <[http://taxprof.typepad.com/taxprof\\_blog/files/2005-21313-1.pdf](http://taxprof.typepad.com/taxprof_blog/files/2005-21313-1.pdf)>.

<sup>58</sup> Li, J, and Picolo, D., 'Reviving the Modern Rule of Interpretation of Tax Statutes: Baby Steps Taken in Canada Trustco, Mathew, Placer Dome and Imperial Oil' <<http://ssrn.com/abstractid=1020653>>;

*Footnote continues over page*

In light of the conflicting opinions with regards to the interpretation of the GAAR, the decisions of the courts will be critical in clarifying its application.<sup>59</sup> The broad terms of the provision leave the courts free to refer to the strong body of overseas precedents for guidance as to the circumstances in which the GAAR should apply. Given an express reference to the Australian GAAR in the 2005 Discussion Paper that led to the 2006 amendments, it could be expected that developments in Australia may be highly instructive. In addition, the prescriptive nature of the South African GAAR might provide some useful guidance in relation to the resolution of future GAAR cases in Australia or as to the direction of future amendments. In the next two sections, the authors will outline the Australian GAAR and consider the jurisprudence on the provision and lingering issues.

#### IV THE AUSTRALIAN GAAR

The Australian GAAR is contained in Part IVA of the *Income Tax Assessment Act 1936*. Its application requires the Commissioner to make a determination as to the existence of the following elements:

- *Scheme*: this element is defined broadly to encompass any agreement, arrangement, understanding, promise or undertaking whether express or implied and whether or not enforceable, and any scheme, plan, proposal or action whether or not unilateral;<sup>60</sup>
- *Tax benefit*: while the definition is couched in a number of disparate sections and has been broadened over time, essentially this element focuses on where there has been a reduction in a taxpayer's tax liability, where that reduction would not reasonably have been expected to have occurred had the scheme not been entered into.<sup>61</sup> Notably, a tax benefit does not include the circumstances where the tax liability has been reduced by virtue of the taxpayer making an election or choice expressly provided for in the legislation, provided the scheme was not entered into in order to create the circumstances where the election thereby became available;<sup>62</sup>
- *Dominant purpose to obtain a tax benefit*: whether the dominant purpose behind entering into the scheme was to obtain the tax benefit is to be assessed by reference to a number of criteria including:

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Geldenhuis, B, above n 56, 9, where it is suggested that *Income Tax Act 1985* (Canada) s 245(4) sparked a revival of the purposive approach to interpretation in Canada. However, the purposive approach to interpretation has been continually applied since the enactment of the South African Constitution in 1996 and thus the possible inclusion of this principle via the GAAR is nothing more than an enshrinement of the purposive approach into the legislation.

<sup>59</sup> Arendse, above n 53.

<sup>60</sup> *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), ss 177A(1), (3).

<sup>61</sup> ITAA 1936, ss 177C(1), 177CA. The reduction in liability is prescribed to have occurred by either an amount of assessable income (or capital gain) not being included, a deduction, capital loss or foreign tax credit being available, or withholding tax not being payable.

<sup>62</sup> ITAA 1936, ss 177C(2), (2A), (3) (with some expressed exceptions).

- the manner in which the scheme was carried out;
- the form and substance of the scheme;
- the timing of the scheme;
- the result that would otherwise have been achieved by the scheme;
- any change in the taxpayer’s financial position or that of a person connected with the taxpayer as a result of the scheme;
- any other consequences for the taxpayer or a connected person of the scheme; and
- the nature of the connection.<sup>63</sup>

Where the Commissioner determines that Part IVA applies, the scheme can be set aside for tax purposes and the taxpayer’s affairs reconstructed with the resultant (negative) tax implications (that is, the tax benefit is cancelled)<sup>64</sup> and penalties applied.<sup>65</sup>

## **V ISSUES ARISING IN THE AUSTRALIAN CASE LAW**

The terms of Part IVA are expressed very broadly and, on the face of it, the provisions could conceivably apply to any transaction or arrangement where the minimisation of the payment of tax was a feature. However such a broad drafting had proved to be the nemesis of the forerunner to the 1981 GAAR,<sup>66</sup> with the courts taking a restrictive approach to its interpretation.<sup>67</sup> Possibly with the fear that Part IVA would meet a similar fate, it remained on the statute books for eight years before the Australian Tax Office (‘ATO’) engaged in any substantial litigation in relation to it<sup>68</sup> and a further five years before the first High Court decision.<sup>69</sup>

### ***A The Dominant Purpose Element***

The primary response to the enactment of the provision by tax advisers has been to focus on the requirement that the tax benefit be the ‘dominant’ purpose of the scheme.<sup>70</sup> It was considered that this requirement imported an essentially ‘business purpose’ defence into the part such that, if it could be established that the overall focus of the scheme was on achieving a commercial end, then the existence of tax minimisation elements would not offend the GAAR. This view was supported by reference to observations made by the Treasurer in his second reading speech when introducing the

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<sup>63</sup> ITAA 1936, ss 177D, 177A(5).

<sup>64</sup> ITAA 1936, ss 177F(1), (2A). The Commissioner also has the power to make compensating adjustments including, for example, to exclude income from another person’s assessable income: ITAA 1936, s 177F(3).

<sup>65</sup> See *Taxation Administration Act 1953*, sch 1, sub-div 284–C. The base penalty amount is 50% of the amount of tax avoided under the scheme, although only a 25% penalty will apply if it is reasonably arguable that Part IVA does not apply.

<sup>66</sup> ITAA36 s 260.

<sup>67</sup> Discussed in Dabner, J, ‘Tax Planning for Professional People — What Remains after the Unholy Trinity’ (1987) 21(8) *Taxation in Australia* 568.

<sup>68</sup> *Case W58 89 ATC* 524.

<sup>69</sup> *FCT v Peabody* 94 ATC 4663. Generally see Cooper, GS, ‘The Emerging High Court Jurisprudence on Part IVA’ (2006) 9(5) *Tax Specialist* 273.

<sup>70</sup> Although prior to amendments to the definition schemes that eluded the initially narrow definition of ‘tax benefit’ were devised, for example by converting a revenue amount into a (less) taxable capital gain.

Bill containing the part to Parliament, when he stated that the part was not intended to apply to ordinary business and family dealings but rather only to schemes of a 'blatant, artificial or contrived kind'.<sup>71</sup> One reaction to this in practice (at least from the experience of one of the authors) was the preparation of lengthy (it was hoped self-serving) advices that would elaborate on all the non-tax advantages of a particular structure or arrangement, with only a brief mention of the (apparently incidental) tax benefits.

However, there were early indications that the requirement that the tax avoidance purpose be 'dominant' might not be the tax planner's panacea. Firstly, there was no definition of 'dominant' and so some debate as to whether it meant dominant as against the combined force of all the other purposes of an arrangement or merely the greatest purpose when viewed against each other purpose individually.<sup>72</sup> Secondly, while the literal interpretation of tax statutes that had plagued the precursor to Part IVA was losing favour in the courts, giving way to a more purposive approach, there was no guarantee that the courts would look to the second reading speech for guidance in the application of the part. Notwithstanding common law developments in support of a more contextual approach to interpretation,<sup>73</sup> and the enactment of ss 15AA and 15AB of the *Acts Interpretation Act* 1901, which specifically endorsed a reference to Parliamentary proceedings as an aid to interpretation, the meaning of the words of the legislation were to remain paramount, and reference to these external sources would only be mandated where the wording of the Act was ambiguous or obscure or the ordinary meaning led to a manifestly absurd or unreasonable result. Thus, it was always open to the courts to sidestep any reference to this ancillary material by asserting that the meaning of the Part was clear in any event, as indeed they subsequently did.<sup>74</sup>

Thirdly though, and much more significantly, the potential limitations on the requirement for any tax avoidance purpose to be dominant were inherent in the reference in s 177D to the fact that in ascertaining whether a dominant purpose existed reference was to be had to the features of the scheme 'or any part' thereof. Thus, it was always conceivable that the Commissioner might be selective in determining the elements of the scheme in such a way as to focus on any tax minimisation features to the exclusion of other commercial elements or aspects motivated by family concerns. For example, while a taxpayer might seek to justify the existence of a discretionary trust through which to conduct a family business by reference to asset protection and succession planning, the existence of tax effective distributions of income might be selected out as the impugned scheme, with the ready conclusion that the amounts of the

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<sup>71</sup> Commonwealth, Parliamentary Debates, House of Representatives, 27 May 1981, 2683–2684 (The Hon John Howard, Treasurer). The Explanatory Memorandum to the Bill that inserted the part confirmed that it was not intended to apply to 'arrangements of a normal business or family kind': Explanatory Memorandum, Income Tax Laws Amendment Bill (No 2) 1981 (Cth), 3.

<sup>72</sup> The case law supports the view that the dominant purpose is the 'ruling, prevailing or most influential purpose': *FCT v Spotless Services Ltd* 96 ATC 5201, 5206. This is, notwithstanding that the Explanatory Memorandum to the Bill that inserted the part suggested a higher standard that the dominant purpose was one that outweighed all the other purposes put together: Income Tax Laws Amendment Bill (No 2) 1981 (Cth), cl 7.

<sup>73</sup> *Cooper Brookes (Wollongong) Pty Ltd v FCT* (1981) 11 ATR 949.

<sup>74</sup> For example, see *Case W58* 89 ATC 524.



distributions (especially to children and a non-working spouse) could only have been justified on tax minimisation grounds. This presented the Commissioner with a ready means to elude the dominance requirement of the tax avoidance purpose specified in the Part.

Initial opinions sought to avoid this result by suggesting that the scheme at issue had to encompass all the elements that hung together to form it. In fact, early case law gave some encouragement to this view, stating a test that the elements of the scheme identified by the Commissioner must be such that they were capable of standing on their own without being robbed of all practical meaning.<sup>75</sup> The position established by subsequent case law on this point is problematic. While there is an acknowledgement, on one hand, that the terms of the legislation authorise the Commissioner to select out the elements of the scheme as he sees fit (and, indeed, he may allege differently defined schemes in the alternative), other cases have emphasised that in applying the Part to the scheme the context in which the scheme occurs has a bearing on determining what the dominant purpose was. Indeed, the latest High Court decision focusing on this point<sup>76</sup> is unsatisfactory, with the various judges stating the requirement in different ways, leaving most commentators free to take whatever they wish from the case.<sup>77</sup>

### ***B No Business Purpose Defence***

Meanwhile, subsequent case law developments rejecting any overall business purpose defence (most famously *FCT v Spotless Ltd*)<sup>78</sup> brought initial howls of derision from the tax advising community, accompanied even by some suggestions that it was now incumbent on taxpayers to select the form of a transaction that resulted in the greatest amount of tax payable. However, subsequent analysis of the facts of *Spotless* by some commentators suggested that it had features of 'a blatant, artificial or contrived scheme', of which the then Treasurer had complained about some 15 years earlier.<sup>79</sup> The judiciary, possibly fearing that they may have gone too far in rejecting a business

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<sup>75</sup> *FCT v Peabody* 94 ATC 4663.

<sup>76</sup> *FCT v Hart* 2004 ATC 4599.

<sup>77</sup> See the discussion in Dabner, J, and Burton, M, 'Hart – the death of tax planning?' (2004) *CCH Tax Week Issue* 24 [488] and Dabner, J, 'So just what did Hart decide: Macquarie Finance' (2004) *CCH Tax Week Issue* 45 [940].

<sup>78</sup> 96 ATC 5201.

<sup>79</sup> And so failed the 'smell test' according to some commentators: D'Ascenzo, M, 'Substance Versus Form' (1997) 3 *Asia-Pacific Tax Bulletin* 330, 335–336. The decision was very controversial and had both its supporters and detractors. For the differing views as to the implications of the decision see Grbich, Y, 'Does Spotless excise Barwick's ghost' in Deutsch, R, (Ed) *Tax Catchups — A prospect intelligence report* (1997) 88, 89; Watts, M.J, 'Part IVA of the Income Tax Assessment Act after Spotless — A Brave New World?' (1998) 72 *The Australian Law Journal* 303; Vann, R, and Allerdice, R, 'Through a Spotless Glass, Darkly' (1997) 31 *Taxation in Australia* 368, 370; Kamenetzky, B, 'Spotless!' (1997) 31 *Taxation in Australia* 364, 367; Harris, P, 'Australia's general anti-avoidance rule Part IVA has teeth but are some missing?' [1998] *British Tax Review* 124, 134–135; D'Ascenzo, M, 'Part IVA — Post Spotless' (1998) 1 *Journal of Australian Taxation* 3; Michael Carmody (Federal Commissioner of Taxation), 'Part IVA — Where to Draw the Line' (Address presented at the 13th National Convention of the Taxation Institute of Australia, Melbourne, 19 March 1997); Greenbaum, A, 'Anti avoidance principles — new directions for tax and business resulting from the High Court decision in Spotless' (1997) 25 *Australian Business Law Review* 142, 146; and Dabner, J, 'The Spin of a Coin — in search of a workable GAAR' (2000) 3(2) *Journal of Australian Taxation* 232–252.

purpose defence, also retreated from too broad an application of *Spotless* in subsequent cases, and a dichotomy in the case law began to develop between artificial schemes that made no commercial sense in the absence of the tax benefits, where Part IVA was readily applied, and more commercial arrangements, where its application was less certain. So, on one hand, there have been cases where the application of the Part to what has become known as ‘mass marketed schemes’ was uncontroversial,<sup>80</sup> while on the other hand, the establishment of business structures for asset protection purposes,<sup>81</sup> sale and leaseback arrangements,<sup>82</sup> stapled security capital raising arrangements,<sup>83</sup> group finance company structures,<sup>84</sup> pre-disposal reconstructions,<sup>85</sup> and elements of a global reconstruction<sup>86</sup> have all been held to be outside the reach of the Part.

### **C Objective Test of Purpose**

These cases have also confirmed that the test contained in Part IVA is a predication test, that is, it is the objective purpose of the scheme that is at issue and the taxpayer’s subjective purpose is irrelevant.<sup>87</sup> Thus, the eight objective factors stated in s 177D(b) are the sole focus<sup>88</sup> criteria with a view to determining what was the purpose of the scheme.<sup>89</sup> These factors include the intention of a taxpayer’s adviser to the scheme,<sup>90</sup> which anecdotal evidence suggests encouraged some ‘tax advisers’ to reinvent and

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<sup>80</sup> The arrangements in these cases are often characterised by elements of non-arm’s length dealings, the ‘round-robin’ of funds, book entries effecting the scheme, and the lack of commercial sense but for the tax benefit. For example, see: *FCT v Sleight* 2004 ATC 4477, *Pridecraft Pty Ltd v FCT*; *FCT v Spotlight Stores Pty Ltd* 2005 ATC 4001, and *FCT v Lenzo* [2008] FCAFC 50. Contrast *Cooke v FCT* 2002 ATC 4937, where the otherwise suspect arrangement was saved by the fact that it was expected to make a commercial return to the investors irrespective of any tax advantage. Also see *Citigroup Pty Ltd v FCT* [2011] FCAFC 61, where an arrangement involving the acquisition of bonds and the subsequent sale of the right to receive the coupons on those bonds, structured to access foreign tax credits, was struck down due to its artificial air and the fact that it made no commercial sense absent the entitlement to the tax credits. Similarly, in *British American Tobacco Australia Services Ltd v FCT* [2010] FCAFC 130, Part IVA applied to a scheme to avoid capital gains tax on the disposal of a business by establishing circumstances where the taxpayer could avail itself of rollover relief. This is an unusual case, in which the broader purview of the relevant scheme actually damaged the taxpayer’s case rather than enhanced it.

<sup>81</sup> *Mochkin v FCT* 2003 ATC 4272.

<sup>82</sup> *Eastern Nitrogen v FCT* 2001 ATC 4164.

<sup>83</sup> *Macquarie Finance Ltd v FCT* 2005 ATC 4829.

<sup>84</sup> *FCT v Ashwick (Qld) No 127 Pty Ltd* [2011] FCAFC 49.

<sup>85</sup> *Futuris Corporation Ltd v FCT* [2010] FCA 935, *FCT v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 (scrip-for-scrip rollover in lieu of sale), and *RCI Pty Ltd v FCT* [2011] FCAFC 104 (asset revaluation and dividend up prior to sale).

<sup>86</sup> *Noza Holdings Pty Ltd v FCT* [2011] FCA 46.

<sup>87</sup> *FCT v Spotless Services Ltd* 96 ATC 5201, 5210.

<sup>88</sup> Viewed in a holistic way, without any need to prioritise between them or detail any respective weights to be attached to each factor: for example, see *FCT v Consolidated Press Holdings Ltd (No 1)* 99 ATC 4945, 4971.

<sup>89</sup> The GAAR subsequently inserted in the goods and services tax legislation, whilst drawing on Part IVA, put this beyond doubt by stating that the question is as to the sole or dominant purpose or the *principal effect* of the scheme: *A New Tax System (Goods and Services Tax) Act 1999*, div 165.

<sup>90</sup> *FCT v Consolidated Press Holdings Ltd (No 1)* 2001 ATC 4343, 4360.

market themselves as 'business consultants' in an attempt to avoid an adverse inference being drawn from their engagement.<sup>91</sup>

### **D The 'Alternative Postulate' Issue**

More recently the primary issue that has emerged with the application of Part IVA has become known as the 'counterfactual' or 'alternative postulate' issue. This arises by virtue of the way in which the definition of 'tax benefit' is couched. For example, a tax benefit arises by virtue of s 177C(1)(a) where an amount is not included in the assessable income of a taxpayer where it might have reasonably been expected to have been included but for the scheme. Thus, this requires a consideration of the alternative ways in which a transaction might have been carried out, and requires the taxpayer — on whom the onus of proof rests — to demonstrate that, while there may have been a number of plausible (not merely possible)<sup>92</sup> alternative ways of effecting the transaction, the tax outcomes would have been the same.<sup>93</sup> The enquiry will typically resolve itself in the taxpayer seeking to establish that the alternative postulated by the Commissioner is not a reasonable alternative.<sup>94</sup>

It is in relation to this enquiry that there is often disagreement amongst the judiciary,<sup>95</sup> and on this point reasonable people will often reasonably disagree: hardly much consolation for a taxpayer seeking some certainty in the application of the tax laws. On some occasions, the Commissioner's alternative postulate will be rejected by the courts as unreasonable in that no reasonable business person would adopt such an approach given the tax cost should alternatives exist.<sup>96</sup> In fact, it has proven to be a source of irritation to the Commissioner that taxpayers have sometimes successfully been able to argue that the only reasonable alternative to the transaction they effected would have been to have done nothing, in which case no assessable income would have been derived, and so no tax benefit within the terms of s 177C(1)(a) had arisen by virtue of the scheme.<sup>97</sup> The Government had announced in 1999 its intention to remove the

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<sup>91</sup> Note that the part is triggered where it could be concluded that a person who entered into or carried out the scheme did so for the specified purpose, and this person need not be the taxpayer obtaining the tax benefit: *Grollo Nomonees Pty Ltd v FCT* 97 ATC 4585 and *De Simone v FCT* [2009] FCAFC 181.

<sup>92</sup> See *FCT v Peabody* 94 ATC 4663.

<sup>93</sup> Not that the alternatives themselves may have amounted to unacceptable tax avoidance schemes: discussed in Cooper, above n 1; see also Dabner and Burton, 'Hart – the death of tax planning?', above n 77, and *Futuris Corporation Ltd v FCT* [2010] FCA 935.

<sup>94</sup> See, for example, *Futuris Corporation Ltd v FCT* [2010] FCA 935 and *FCT v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134, although note *RCI Pty Ltd v FCT* [2011] FCAFC 104 (discussed below), where the Full Federal Court has cast doubt on this way of describing the issue seemingly downplaying the onus on the taxpayer.

<sup>95</sup> For example, see Hill J at first instance in *Macquarie Finance Ltd v FCT* 2004 ATC 4866, where his Honour also acknowledged the interpretative uncertainties with the part following the then most recent High Court decision in *FCT v Hart* 2004 ATC 4599.

<sup>96</sup> For example, see *RCI Pty Ltd v FCT* [2011] FCAFC 104.

<sup>97</sup> *Ibid*, where one of the alternatives postulated by the taxpayer – and accepted by the Court – was that they would not have proceeded with the transaction (ie would have done nothing) had the only way to effect it been in the form proposed by the Commissioner.

availability of the 'would have done nothing' argument but no amendment has been forthcoming.<sup>98</sup>

By way of further illustration of the alternative postulate principle, a tax benefit also arises by virtue of s 177C(1)(b) where a deduction is available to a taxpayer where it might have reasonably been expected not to have been available but for the scheme. Again, this requires a consideration of whether the taxpayer might have reasonably achieved a deduction from an alternative transaction. There is some dispute in the case law as to whether any alternatives postulated by the taxpayer must result in a deduction of the same or similar kind.<sup>99</sup> If the deduction must be of the same kind then it might be more difficult for a taxpayer to avoid the finding that a tax benefit exists.

The most recent decision on the alternative postulate principle is the Full Federal Court decision in *RCI Pty Ltd v FCT*.<sup>100</sup> The issue was whether the taxpayer had achieved a tax benefit within the meaning of Part IVA when it sold its shareholding in a foreign subsidiary to another company within the corporate group as part of a restructuring. Prior to the sale, it had arranged for the subsidiary to revalue its assets and pay up a (non-taxable) dividend, thereby reducing the value of the shares to be sold, and hence the amount of assessable capital gain derived on the sale. At first instance, the Trial Judge rejected the taxpayer's argument that the Commissioner's alternative postulate of selling the shares without the asset revaluation and dividend strip was unreasonable, the taxpayer having suggested that the true reasonable postulate was that it would have done nothing rather than crystallise a massive tax liability. However, this decision was reversed by the Full Federal Court on the basis that the true enquiry is not whether the taxpayer had proved that the Commissioner's alternative was unreasonable but rather what the taxpayer might have reasonably been expected to have done had it not entered into the scheme. The Court was of the view that, given the size of the potential tax liability from a straight share sale, (\$207 million or 15% of market capitalisation) this compelled the conclusion that there was 'no possibility, let alone an expectation' that the sale would have taken place in the form suggested by the Commissioner.<sup>101</sup> In the event that they were wrong on this point, their Honours also examined the issue of the dominant purpose of the arrangement, concluding that they could not be satisfied that it was to obtain any suggested tax benefit. Notably their Honours in *RCI* acknowledged the inherent uncertainty in the outcome in Part IVA cases, suggesting that this criticism should be directed at the architecture of the legislation rather than the processes of the court.<sup>102</sup>

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<sup>98</sup> Commonwealth Treasurer, *New Business Tax System: Stage 2 Response*, No 74 (1999).

<sup>99</sup> Contrast the differently constituted Full Federal Court decisions of *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 (need not be of the same kind) and *FCT v Lenzo* [2008] FCAFC 50.

<sup>100</sup> [2011] FCAFC 104.

<sup>101</sup> *Ibid*, 145. For a similar reaction by the courts to the Commissioner's very tax ineffective alternative postulate see *FCT v News Australia Holdings Pty Ltd* 2010 ATC 20-191. Thus, there is a tension here that the Commissioner is required to assert a less tax effective reasonable alternative postulate in order to establish a tax benefit, but if it is too tax ineffective, then the court may conclude that it was, in fact, not reasonable: discussed in Cooper, above n 1. Cooper suggests that this new battleground for Australian Part IVA cases has witnessed experts playing an increasing role opining on what was commercial (normal) or plausible.

<sup>102</sup> *RCI Pty Ltd v FCT* [2011] FCAFC 104, 140.

## VI POSSIBLE LESSONS FOR THE INTERPRETATION OF THE RESPECTIVE GAARS

While the Australian and South African GAARs have different design features, the authors argue that there is a commonality in the essential elements, namely:

- there must be an arrangement (SA) or scheme (Aus);
- there must be a tax benefit amounting to less tax being paid;<sup>103</sup>
- the avoidance arrangement or scheme must have been entered into for the sole or main purpose (SA) or dominant purpose (Aus) of obtaining a tax benefit; and
- with this determined by reference to specified factors (Aus) or if the arrangement was not normal or there has been a misuse or abuse of the provisions of the Act or (in a business context) the arrangement lacks commercial substance by reference to prescribed circumstances (SA).

It is clear that the greatest divergence between the two GAARs is in relation to the fourth element. However, upon delving deeper into the Australian case law, the differences may be more apparent than real.

Firstly, as noted above, a dichotomy has arisen within the Australian jurisprudence between schemes that make no sense but for the tax benefits and other arrangements that might be explained on more commercial or domestic considerations. Many of the failed schemes have involved promoters who mass market the arrangement. Typical features of these arrangements are that there is considerable doubt as to whether the taxpayer will generate a pre-tax return, the arrangement, or part of it, is effected by book entries or a round robin of funds, and there are non-arm's length entities or transactions. In South African GAAR terms it could be said that such arrangements lack commercial substance.<sup>104</sup> Interestingly, many of the criteria identified in ss 80C–80E as indicators of a lack of a commercial substance have been focused upon by the Australian courts upon a consideration of the factors mandated by s 177D(b). So, for example, whether the arrangement has a real effect on the financial position of the taxpayer, or some other consequence, is a factor made relevant by both sets of legislation.<sup>105</sup> Similarly, a consideration of differences arising from the form and substance or the arrangement is expressly mandated by both GAARs.

The South African legislation is more prescriptive than the Australian. This may subsequently prove to be both a curse and a blessing, depending on whether the South

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<sup>103</sup> Although see above n 61.

<sup>104</sup> Although it is to be observed that many of the Australian mass marketed schemes do not occur in a business context and so the commercial substance element of the South African GAAR would not strictly be relevant. The rationale for the restriction of this element to the business context is questionable. Indications of the reason for this restriction may be evident in the 2005 Discussion Paper, in which SARS describes the common characteristics of avoidance schemes. In this discussion, it is clear that SARS was particularly concerned with the trend that businesses were viewing the tax department as a 'profit centre', resulting in the increased use of avoidance schemes. Otherwise no express explanation has been provided for the restriction of Income Tax Act 1962 (SA) ss 80C, 80D, and 80E to arrangements within a business context.

<sup>105</sup> Obvious examples caught by both sets of legislation would involve a round-robin of funds or some type of reimbursement agreement.

African courts feel constrained in referring to broader considerations.<sup>106</sup> The benefit is in the greater guidance given to the courts. Indeed, while the Australian judiciary has readily focused on round robin financing (cf SA GAAR, s 80D) and offsetting and cancelling elements (cf SA GAAR, s 80C(2)),<sup>107</sup> a detailed reference to ‘accommodating or tax-indifferent’ parties (cf SA GAAR, s 80E) has not been a consideration that has been necessarily focused on by the Australian courts. While the terms of s 177D(b)(vi) might conceivably encourage a consideration as to whether such entities are at play, no Australian case has, to the authors’ knowledge, yet made reference to such entities in its Part IVA deliberations. Certainly, the detail in s 80E assists in focusing the courts’ attention on the possible application of the GAAR in circumstances where a counter party to a transaction is tax-indifferent, and especially where they may be resident in a tax haven.<sup>108</sup>

While the misuse/abuse limb of the South African GAAR has no express Australian equivalent, apparently being drawn from the Canadian provisions, it was observed earlier that commentators on the Canadian GAAR have questioned whether this element of their GAAR adds anything beyond the general legislative interpretative principles.<sup>109</sup> In an environment where the dominant approach to statutory interpretation is to adopt a purposive approach, arguably arrangements directed at avoiding or inappropriately taking advantage of substantive provisions of the tax laws are less likely to be countenanced without the need to fall back on a GAAR. In fact, one of the authors has questioned elsewhere the need for a GAAR where an (expanded) purposive approach to interpretation (together with other legislative elements) is adopted.<sup>110</sup>

The Australian judiciary has been inconsistent in its adoption of a purposive approach to the interpretation of tax statutes, with the less judicially active literal approach that prevailed in the 1970s and early 1980s still occasionally finding some support.<sup>111</sup> Nevertheless, the case law is replete with examples of a purposive approach being adopted, typically acknowledging the application of a substantive provision to an

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<sup>106</sup> The legislation specifically provides that it is stating a non-exclusive set of considerations.

<sup>107</sup> Examples of Australian GAAR decisions where round robin financing was found to be a significant to the application of the provision include *FCT v Sleight* 2004 ATC 4477 and *Pridecraft Pty Ltd v FCT*; *FCT v Spotlight Stores Pty Ltd* 2005 ATC 4001. In a sense, the case of *Citigroup Pty Ltd v FCT* 2011 FCAFC 61 might also be viewed as having elements of an offsetting nature in that the taxpayer had essentially acquired foreign and bonds and sold the right to receive the coupons on the bonds in order to attract foreign tax credits. The acquisition and part disposal partially offset each other from the perspective of the taxpayer’s financial exposure.

<sup>108</sup> The need to consider the application of the GAAR in such circumstances may be more paramount in South Africa than Australia given that the transfer pricing provision in *Income Tax Act 1962* s 31(2) is more curtailed, its application being restricted to connected persons, whereas the Australian provisions have no such limitation: ITAA36 s 136.

<sup>109</sup> See above n 56.

<sup>110</sup> See Dabner, J, ‘In Search of a Purpose to our Tax Laws’ (2003) *Journal of Australian Taxation* 32–77 and Dabner, J, ‘There are too many witchdoctors in our tax courts: is there a better way?’ (2005) 15 *Revenue Law Journal* 36.

<sup>111</sup> One member of the High Court has spoken out against judicial activism on a number of occasions, for example: Heydon, D, ‘Judicial Activism and the Death of the Rule of Law’ (2003) XLVII (1–2) *Quadrant Magazine* 9.

arrangement designed to circumvent it.<sup>112</sup> This supports the view that a purposive approach could now be expressed as the predominant statutory interpretation rule adopted by Australian tax courts.

Given that the South African courts have had less hesitation adopting a purposive approach (at least since the 1996 Constitutional reforms),<sup>113</sup> the insertion of the misuse/abuse limb should merely serve to reinforce the need, at least where an avoidance arrangement is established, to consider whether the arrangement seeks to defeat the purpose to which a substantive provision is directed. Ultimately, the approach adopted in both countries should be similar.

On an initial consideration, the 'normality' element would seem to be peculiarly South African and to have no Australian equivalent. Thus, an avoidance scheme entered into for the sole or main purpose of obtaining a tax benefit will be caught by the South African GAAR, where it was entered into by means or in a manner which would not normally be employed for bona fide (business) purposes other than to obtain a tax benefit or it created rights or obligations that would not normally be created by parties dealing at arm's length. The difficulties encountered by the South African courts in ascertaining what is a normal arrangement were referred to in Parts II and III of this paper. It is now clear that just because the arrangement is commonly employed will not render it normal.<sup>114</sup> However, it remains unclear to what extent the circumstances of the taxpayer can be taken into account in determining the dividing line between normality and abnormality, although the intent of the 2006 amendments was arguably to render the test solely objective. Similarly untested is the significance of the reference to bona fide (business) purposes. If the intention was to create a business purposes defence, then this is inconsistent with the approach that has been adopted in Australia. On the other hand, the insertion into the GAAR, by way of s 80H, of an acknowledgement that the Commissioner may apply the GAAR to *parts* of an arrangement might enable SARS to both elude the sole or main purpose criterion, and also thereby possibly play down the significance of any business purpose elements of an arrangement, as it was explained in Part IV of this paper is a feature of the Australian environment.

While the Australian legislation avoids an express carve out for 'normal' arrangements, this language has entered the Australian GAAR vernacular by virtue of both the second reading speech and explanatory memorandum that accompanied the introduction of the Bill that inserted Part IVA into the legislation. It was said that the provisions were not intended to apply to 'ordinary' or 'normal' business or family dealings. While these documents have been held to have only a limited relevance to the application of the Australian GAAR, the undertone remains.<sup>115</sup> Arguably, where the sentiment has

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<sup>112</sup> One example is the decision at first instance in *Macquarie Finance Ltd v FCT* 2004 ATC 4866, where Hill J held that 'interest' payments under a stapled securities arrangement were not deductible under the substantive provisions, but had they been, then Part IVA would have applied in any event.

<sup>113</sup> Geldenhuys, above n 56, 91.

<sup>114</sup> Compare the position established in Australia in the very first Part IVA case, *Case W58 89* ATC 524, in response to the argument relying on the second reading speech that an arrangement was a ordinary business or family dealing because it was commonly carried out.

<sup>115</sup> Even though no Australian court has embraced the extrinsic material for the purpose of limiting the application of the part, the language in this material has found a place in Australian lore and practice. So,

*Footnote continues over page*

manifested itself to the greatest extent, is in the identification of a tax benefit. As discussed above, this necessitates a comparison between the tax position achieved under the scheme and the tax position that would have been achieved had alternative reasonable arrangements been adopted (the alternative postulate). In the terms of the legislation, it requires a consideration of how the taxpayer might reasonably have been expected to have structured the transaction. Put this way, the similarities with the normality question in South Africa are obvious. Inherent, therefore, in the Australian GAAR is an implicit consideration as to whether the transaction engaged in by the taxpayer is normal in the sense of being a reasonable commercial response to the circumstances. As illustrated in Part IV, this aspect of the application of the Australian GAAR has been especially plagued with doubt, with reasonable people reasonably disagreeing.

If our analysis is correct, and the two GAARs have essentially the same purview, then the considerable Australian case law on Part IVA should be of value in giving some indication of the circumstances in which the South African GAAR should have an application. This case law might also assist in some interpretative issues. Thus, it could be suggested that a 'no overall business purpose' defence should be available in South Africa, notwithstanding aspects of s 80A, and especially because of s 80H. Furthermore, the test should be solely objective: a consideration of what was the purpose of the arrangement by reference to objective factors, rather than a consideration as to the taxpayer's subjective purpose. And while the existence of four elements that are more prescribed than the more generally drafted the three Australian elements, might initially at least found a concern that the South African GAAR could continue to be weakened, the overall similarities with the Australian position might alleviate these fears.<sup>116</sup>

Finally, from an Australian perspective, while there is as yet no South African jurisprudence on the GAAR to which to refer, the legislation is much more prescriptive than the Australian GAAR, the lack of which provides very little guidance for the courts. While many of the issues associated with the interpretation of the Australian provisions have now been resolved, nevertheless the detail in the South African GAAR on circumstances where the lack of commercial substance could be presumed might be usefully referred to in future Australian GAAR cases or, possibly more likely, in amendments to the provisions to differentiate between those arrangements with a contrived and artificial flavour and those less likely to be impugned by the legislation. Certainly, Australian jurisprudence referring to round robin elements and transfers by book entries already exists. However, the express recognition of 'accommodating or tax-indifferent' parties, together with the extensive definition of these terms, might provide a valuable reference point for Australian judges.

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for example, there is a compact between the ATO and taxpayers that salary sacrifice arrangements are not impugned by the legislation: but see *Yip v FCT* 2011 ATC 10-214, discussed in Dabner, J, 'Yippy Yi Yo (An analysis of Yip's case)' (2011) *CCH tax Week* Issue 46 [1048].

<sup>116</sup> The authors acknowledge the limitations in transplanting principles developed in a different statutory and social context, but nevertheless suggest that, in a global environment where tax law harmonisation is increasingly being seen as important, a consideration of the approach adopted in similar foreign jurisdictions is appropriate.



## VII CONCLUSION

The global phenomenon of tax avoidance shows no sign of abating. With the emergence of a global community, even larger multinational conglomerates and more sophisticated transactions the risks for national treasuries are growing. Governments have responded with more complex and robust tax legislation. Typically a GAAR is part of the arsenal that is employed, often appearing as the centre piece. Both Australia and South Africa have sought to counter tax avoidance in this way. However, the GAAR has been no magic bullet and both countries have had to respond to its limitations and seek to enhance its robustness. Over the last two decades, success in the courts has demonstrated that the post-1981 Australian GAAR has been up to the challenge. Meanwhile, the South African Government has had to continue to tinker with its provision in an effort to address inadequacies. The last amendments were in 2006, but in the absence of case law since then, it is unclear whether these were effective.

A comparison between the two sets of provisions reveals considerable design differences. However, on closer analysis, and with the aid of the Australian case law, the differences might merely be cosmetic. If so, the Australian case law may afford some insight into the nature of the arrangements that the South African GAAR might subsequently impugn, and how it might be applied. In particular, it is conceivable that it could have an application premised on purely objective factors and will not be curtailed by an overall business purposes defence.

Given that the Australian jurisprudence appears to have distinguished between schemes with no true commercial substance (which are readily struck down) and those with a more commercial motivation, the prescriptive elements in the South African GAAR illustrating circumstances where a lack of commercial substance can be presumed could be of assistance in guiding the application of the Australian GAAR in future cases. In particular, the focus on round trip financing, offsetting and cancelling elements, and 'accommodating and tax-indifferent' parties could be referred to by the Australian courts in their identification of relevant considerations.

Finally, the difficulties that continue to be encountered by the Australian judiciary in establishing a bright line rule in the application of the 'alternative postulate' principle do not bode well for any clarification in South Africa of the 'normality' principle. On the other hand, some clear South African jurisprudence identifying parameters to distinguish between normal and abnormal transactions might, therefore, be equally welcomed in Australia.



**POST IMPLEMENTATION REVIEWS OF RECENT AUSTRALIAN TAX REFORM**

PAUL KENNY\*

**ABSTRACT**

This paper examines the post implementation review stage of the enacted tax reforms: the non-commercial loss ('NCL') and Simplified Tax System ('STS'), that flowed from the recommendations of the 1999 *Review of Business Taxation*. Within a short period of time, the *Ralph Review* made wide ranging recommendations on the design of the Australian business tax system and since 1999 many of these reforms have gained assent into law. The NCL and STS reforms provide particularly good examples to assess the post implementation review processes, given the significant flaws inherent in the legislation. This paper finds that the post implementation review processes for the NCL and STS were narrowly based, ad hoc, and/or untimely. Such enacted tax reforms need to be subject to a timely and thorough post implementation review process by an independent body. An effective post implementation review process also requires extensive consultation and should be ongoing.

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## I INTRODUCTION

This article critiques the post implementation review stage,<sup>1</sup> and the operation of the Board of Taxation, in respect of the enacted tax reforms associated with the 1999 *Review of Business Taxation* chaired by John Ralph (herein after called the *Ralph Review*).<sup>2</sup> Within a short period of time, the *Ralph Review* made wide ranging recommendations on the design of the Australian business tax system and since 1999 many of these reforms have gained assent into law.<sup>3</sup> Having regard to the enormity of the *Ralph Review* tax reform legislation, this article employs a partial analysis that focuses on the post implementation review processes in respect of two significant reforms, the non-commercial loss rules ('NCL')<sup>4</sup> and Simplified Tax System ('STS').<sup>5</sup> These reforms provide particularly good examples to assess the post implementation review processes, given the significant flaws inherent in the legislation. The NCL rules were introduced as an integrity measure to restrict small business loss deductions where the business is operated by a natural person. The exemptions in these rules, however, greatly stymied its effectiveness. Whilst the STS was a tax expenditure aimed at helping small business, it proved to be impractical. Numerous changes were made to the STS before it was abolished as a system.

This article commences by detailing the federal government's post implementation reviews processes for the *Ralph Review* reforms. The article then provides an overview

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<sup>1</sup> Australian tax reform generally follows a three stage process involving policy formulation, legislation design, and post implementation reviews. This article is the third in a series of three articles by the author on the tax reform processes associated with the 1999 *Review of Business Taxation: Review of Business Taxation, A Tax System Redesigned, More Certain, Equitable and Durable, Report* (1999) (herein after called *A Tax System Redesigned*). The author's first article, on the policy design processes found shortcomings with the *Ralph Review's* problem-identification and policy design processes. Taxation enquiries should adopt a more gradual, transparent, and consultative approach in identifying and researching problems and in drafting taxation reform solutions. In particular there is a great need to carefully develop objectives for specific tax reforms and to build socio-economic modelling capabilities so as to forecast the fiscal adequacy, economic, equity, and simplicity impacts as well as to assess policy outcomes. See P Kenny 'The 1999 Review of Business Taxation: Should we fast track small business tax reform?' (2008) 18(1) *Revenue Law Journal* 6. The author's second article on the legislation design stage of the tax reform processes found that the rapid design of the *Ralph Review's* tax reform recommendations meant that a number of significant flaws emerged in the legislation. The federal government should have adopted a more critical analysis, as well as a transparent and consultative approach to ensure policy goals were met. See P Kenny, (2010) 'Legislative design and tax reform: The weakest link?', 25(2) *Australian Tax Forum* 179.

<sup>2</sup> *A Tax System Redesigned*, above n 1. The Report was the last in a series of four papers published by the Review of Business Taxation.

<sup>3</sup> Michael Dirkis and Antony Ting, 'Cataloguing Business Tax Reform Seven Years On' (2006) 21 *Australian Tax Forum* 601 notes that the Government introduced 144 taxation bills between June 1999 and October 2001: 44 taxation and superannuation related bills in 2002; 20 in 2003; 46 in 2004; 22 in 2005; and 14 by 14 September 2006.

<sup>4</sup> *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) div 35.

<sup>5</sup> ITAA 1997 div 328 and *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) s 82KZM. The small business concessions were known as the 'Simplified Tax System' (STS) concessions up to 30 June 2007. From 1 July 2007, the concessions were renamed as small business entities (SBE) income tax accounting concessions, *Tax Laws Amendment (Small Business) Act 2007*.

of the NCL and STS regimes before analysing the associated post implementation review processes.

The article finds that post implementation review processes for the NCL regime and STS were narrowly based, ad hoc, and/or untimely. Whilst the *Board of Taxation* carried out certain post implementation reviews, these processes were stymied by restrictive terms of reference and what appears to be inadequate funding. Such enacted tax reforms need to be subject to a timely and thorough post implementation review process by an appropriately funded independent body. This process must assess the tax reforms having regard to the generally accepted tax policy criteria.<sup>6</sup> An effective post implementation review process also requires extensive consultation and should be ongoing.

## II THE RALPH REVIEW POST IMPLEMENTATION REVIEW PROCESSES

### *A The “Proposed” Board of Taxation*

Originally, the *Ralph Review* proposed the establishment of an advisory Board of Taxation (herein after known as the ‘*proposed Board*’) with seemingly wide ranging powers to review tax legislation.<sup>7</sup> The *proposed Board* was to review the ongoing development of the business tax system against the national taxation objectives that were to be set out in a proposed *Charter of Business Taxation*.<sup>8</sup> This would overcome the concern in relation to the ‘largely piecemeal approach which has evolved in relation to the development of business taxation policy...’.<sup>9</sup> The functions to be undertaken by the *proposed Board* would include the following functions:<sup>10</sup>

- be the guardian of the proposed Charter of Business Taxation containing the national taxation objectives and taxation design principles, and recommend changes necessary to ensure the Charter remains contemporary;
- ...
- monitor and report on the performance of the business taxation system — and, in this regard, of the Treasury, the ATO (Australian Taxation Office) and the OPC (Office of Parliamentary Counsel) — against the objectives and principles set out in the Charter;

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<sup>6</sup> Economic efficiency, equity, simplicity, and fiscal adequacy. See James Alm, ‘What is an “Optimal” Tax?’ (1996) XLIX *National Tax Journal* 117, 117.

<sup>7</sup> *A Tax System Redesigned*, above n 1, 102–03.

<sup>8</sup> *Ibid*: ‘Consistent with the function of revenue-raising, three major objectives guide the development of the business taxation system: optimising economic growth; promoting equity; and promoting simplification and certainty. The three national taxation objectives are interdependent and must be pursued jointly. Proposed changes to tax law, or to taxation administration, should take account of all three. Any decision to trade off one objective against another should be taken explicitly, after consideration of the anticipated advantages and disadvantages of the various options. In such instances the course which, on balance, delivers the best social outcome should be adopted. The Board of Taxation will have the role of monitoring compliance with these objectives.’

<sup>9</sup> *Ibid* 119.

<sup>10</sup> *Ibid*.

Under this regime, the *proposed Board* would appear to have had scope to undertake post-implementation reviews of taxation laws and recommend changes in keeping with the *Charter of Business Taxation*. However, the federal government rejected this recommendation to establish a *proposed Board* and thereby rejected the proposed Charter.<sup>11</sup>

Subsequently, the Treasurer announced that federal government would in due course 'establish an on-going, non-statutory Advisory Board which would allow access to private sector expertise on a regular basis, not only on business tax but on all aspects of tax law.'<sup>12</sup> Thus, in August 2000, the federal government established the *Board of Taxation* (hereinafter known as the 'Board') under a different model.<sup>13</sup> The Board was to advise on the development and implementation of taxation legislation as well as the ongoing operation of the tax system.<sup>14</sup> The Board would also ensure that there would be full and effective community consultation in the design and implementation of tax legislation.<sup>15</sup>

### **B The Board of Taxation Reviews**

In May 2002, the Treasurer announced an expanded role for the Board that would see it consistently conducting limited post implementation reviews of major pieces of tax legislation 'to ensure that government policy intent has been effectively translated consequent upon consultations undertaken'.<sup>16</sup> Since that time the Board has been directed on an ad hoc basis to conduct post-implementation reviews of tax legislation. Over twelve years the Board has only reviewed five<sup>17</sup> of the many enacted *Ralph Review* reforms (including the NCL rules discussed in this article).

### **C Other Ad hoc Reviews**

Treasury undertook numerous ad hoc amendments to correct technical errors and anomalies and to address obvious policy flaws. Changes were also made as a result of consequential amendments to related laws. Ad hoc post implementation reviews of the *Ralph Review* reforms were also undertaken by other bodies. For example, the STS was subject to a review by a taskforce chaired by Gary Banks ('*Banks Taskforce*') to reduce the regulatory burden on small business (as discussed below).<sup>18</sup>

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<sup>11</sup> Peter Costello, Treasurer, 'The New Business Tax System' (Press Release No 56 of 21 September 1999).

<sup>12</sup> Ibid.

<sup>13</sup> Peter Costello, Treasurer, 'Board of Taxation: Membership' (Press Release No 83 of 10 August 2000).

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Peter Costello, Treasurer, 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design' (Press Release No 22 of 2 May 2002).

<sup>17</sup> Non-Commercial loss legislation contained in ITAA 1997 div 35; Alienation of personal services income rules — ITAA 1997 Divs 84–87; the small business capital gains tax concessions — ITAA 1997 div 152; and certain aspects of the consolidation regime — *Income Tax Assessment Act 1936* (ITAA 1936) pt III Div 7A.

<sup>18</sup> Gary Banks (Chairman), *Taskforce on Reducing the Regulatory Burden on Business Rethinking Regulation*, 31 January 2006, <<http://www.regulationtaskforce.gov.au/finalreport/>>.

### III POST IMPLEMENTATION REVIEWS OF THE NCL RULES

#### *A Overview of the Non-Commercial Loss Legislation*

The NCL legislation contained in div 35 of the *Income Tax Assessment Act 1997* ('ITAA 1997')<sup>19</sup> applies from 1 July 2000 to each and every income year in which an individual<sup>20</sup> taxpayer (whether alone or in a general law partnership)<sup>21</sup> is carrying on<sup>22</sup> a relevant business activity. Division 35 works to quarantine certain losses<sup>23</sup> from such small business activities unless the activity satisfies one of the exception criteria (the primary production and professional arts exemptions, the four objective tests, or the Commissioner's discretions). If none of these exceptions applies, the loss is quarantined and can only be offset against future profits from the same business activity.<sup>24</sup> This carries the loss forward to the next income year or beyond.

The NCL limitations do not apply if the business activity is a 'primary production business' and the taxpayer's assessable income (excluding net capital gains)<sup>25</sup> from other sources that do not relate to that activity is less than \$40,000.<sup>26</sup> Further, the NCL limitations do not apply if the business activity is a 'professional arts business' and the taxpayer's assessable income (excluding net capital gains) from other sources that do not relate to that activity is less than \$40,000.<sup>27</sup>

The assessable income test is the first of the four objective tests and provides that the loss deferral rule will not apply where the amount of assessable income (rather than annual turnover or taxable income) earned from the relevant business activity for the year is at least \$20,000.<sup>28</sup> The profits test<sup>29</sup> provides that the loss deferral rule will not apply for the current year if, for each of at least 3 out of the last 5 income years including the current income year, the relevant business activity makes taxable income.<sup>30</sup> Under

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<sup>19</sup> Notable exceptions to the original *Ralph Reforms* were slight changes to the profits test ('taxable income in 3 out of the last 7 years' test, which was replaced by a 'taxable income in 3 out of the last 5 years' test in ITAA 1997 s 35-55(1)) and the introduction of an exemption for certain small primary production activities, s 35-10(4). The provisions were further amended to include an exemption for certain professional arts activities, s 35-10(4). The *Ralph Review* proposed a \$20,000 annual turnover test but this was replaced by a more restrictive test based on \$20,000 of assessable income in s 35-30.

<sup>20</sup> An 'individual' means a natural person: Australian Taxation Office (ATO), *Income Tax: Division 35 — Non-commercial business losses*, TR 2001/14, 19 December 2001 [34] and ITAA 1997 s 995-1(1) (definition of 'individual').

<sup>21</sup> ATO, *Income tax: whether business is carried on in partnership (including 'husband and wife' partnerships) as to what constitutes a 'general law partnership'*, TR 94/8, 27 January 1994.

<sup>22</sup> 'Carrying on' is defined in ITAA 1997 s 995-1 as 'carrying on an enterprise includes doing anything in the course of the commencement or termination of the enterprise.'

<sup>23</sup> ITAA 1997 s 35-10(1), (2). A loss in respect of a business activity occurs where the allowable deductions attributable to that activity exceed the assessable income from the activity for an income year.

<sup>24</sup> ITAA 1997 s 35-10(1), (2).

<sup>25</sup> 'Net capital gain' is defined in s 995-1 as having the meaning given by ss 102-5 and 165-111.

<sup>26</sup> ITAA 1997 s 35-10(4).

<sup>27</sup> ITAA 1997 s 35-10(4).

<sup>28</sup> ITAA 1997 s 35-30.

<sup>29</sup> ITAA 1997 s 35-35.

<sup>30</sup> Assessable income from the activity exceeds deductions, ITAA 1997 s 35-35(1). The profits test ignores any NCL carried forward losses.

the real property test, the total reduced cost base of real property or interests in real property used on a continuing basis in carrying on the business activity in the year must be at least \$500,000.<sup>31</sup> The loss deferral rule does not apply to a business activity for an income year if the total value of assets that are counted for this test, and are used on a continuing basis in carrying on the activity in the year, is at least \$100,000.<sup>32</sup> Additionally, the Commissioner may exercise his discretion not to apply the loss deferral rule to a business activity for one or more years for businesses that have special circumstances<sup>33</sup> or lead times.<sup>34</sup>

### **B Rationale and Reality**

The tax policy rationale for the NCL rules was principally based on equity, given that the Explanatory Memorandum ('EM') asserted that the measures would contribute significantly to fairness and integrity by reducing the scope for tax minimisation and the deferral of tax by taxpayers.<sup>35</sup> In respect of the other generally accepted tax policy criteria, the EM provided little comment on the specific impact of the NCL system on economic efficiency.<sup>36</sup> The revenue forecast provided for small savings in tax revenue<sup>37</sup> and indicated no clear gain or loss to simplicity.<sup>38</sup>

However, commentators and professional and government bodies found that the NCL regime breached the tax policy criteria.<sup>39</sup> The various NCL exemptions enable many

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<sup>31</sup> ITAA 1997 s 35-40.

<sup>32</sup> ITAA 1997 s 35-45(1).

<sup>33</sup> The first discretion applies if the business activity was or will be affected in that or those income years by special circumstances outside the control of the operators of the business activity, ITAA 1997 s 35-55(1)(a). The special circumstances include drought, flood, bushfire or some other natural disaster, ITAA 1997 s 35-55(1)(a).

<sup>34</sup> This discretion has the following three requirements. First, an individual must have started to carry on a business activity. Second, the business activity must, because of its nature, fail to satisfy one of the four tests set out above in ITAA 1997 ss 35-30, 35-35, 35-40 or 35-45. Third, there must be an objective expectation, based on evidence from independent sources (where available) that, within a period that is commercially viable for the industry concerned, the activity will either meet one of the four tests or produce a profit.

<sup>35</sup> Explanatory Memorandum, New Business Tax System (Integrity Measures) Bill 2000, [1.7]–[1.9].

<sup>36</sup> *Ibid* [3.21]. Only a generic statement on the impact on efficiency was made (found in other enacted *Ralph Review* reforms): that the NCL rules as part of the New Business Tax System 'will provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings'.

<sup>37</sup> *Ibid*, General outline and financial impact. The EM forecast a gain to revenue of \$140 million in 2003–04.

<sup>38</sup> *Ibid* [3.11]–[3.14], [3.19]. The EM asserted that the law would provide some simplification for business after an initial familiarisation period as it would provide a more consistent and easily understood business tax system. There might be an increase in compliance costs for some taxpayers but this would be outweighed by the improvement in the equity, fairness and integrity. The EM also stated the NCL rules would be administered by the ATO using existing resources.

<sup>39</sup> For example see: L Samarkovski and B Freudenberg, 'TLIP: Lip Service or in Service? A Review of the Non-Commercial Loss and STS Measures Against the TLIP principles' (2006) 21 *Australian Tax Forum* 387; P Kenny, 'The Non Commercial Loss Restrictions: A Very Blunt Instrument for Micro Business' (2006) 21 *Australian Tax Forum* 573; L Greenleaf, 'The Non-commercial loss Provisions: A Lesson in Collateral Damage?' (2006) 21 *Australian Tax Forum* 669; Rural Industries Research and Development Corporation, *Economic Effects of Income Tax Law on Investments in Australian Agriculture, With Particular Reference to New and Emerging Industries*, January 2006, <<http://www.rirdc.gov.au/fullreports>>; Submissions to the

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hobby/lifestyle activities to sidestep the loss limitation rules.<sup>40</sup> High income and wealthier taxpayers holding more expensive or larger scale hobby/lifestyle activities (that satisfy one or more of the four tests) are generally unaffected by the loss limitations, given the quantum of these exemptions.<sup>41</sup> These exemptions are inconsistent with the equity and the fiscal adequacy criterion. This is also economically inefficient since exempting such hobby/lifestyle activities encourages inefficient use of scarce resources.<sup>42</sup>

On the other hand, these tests have an onerous effect in preventing losses for genuine businesses, given that over 100,000 individuals are subject to the NCL limitations.<sup>43</sup> Additionally, div 35 failed to replace and simplify existing tax legislation.<sup>44</sup> Rather, these rules added another layer of complexity.

### ***C NCL Post-implementation Review***

#### ***1 The Board of Taxation***

Given the NCL flaws noted above, there appeared to have been significant pressure on the federal government to undertake a post implementation review. In 2002, after 2–3 years of operation of the NCL, Treasury instructed the Board to conduct a post implementation examination of the NCL provisions. The Board was called to assess div 35 with regard to the following criteria to determine whether div 35:<sup>45</sup>

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

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Board of Taxation's 'Post-implementation Review of the Quality and Effectiveness of the Non-commercial Losses Provisions in Division 35 of the *Income Tax Assessment Act 1997*'; R Douglas, 'Farmers Nil, Commissioner Nil. Thanks, Ralph Great Result' (2001) 35 *Taxation in Australia* 387; G Cooper, 'Tax Reform: Non Commercial Losses' (2000) 35 *Taxation in Australia* 160.

<sup>40</sup> Kenny, above n 39, 595–98; Greenleaf, above n 39, 681; Douglas, above n 39, 390–92; Cooper, above n 39, 163.

<sup>41</sup> Ibid.

<sup>42</sup> Rural Industries Research and Development Corporation, above n 39, vi; Submissions to the Board of Taxation's Post-implementation Review, Taxpayers Australia, above n 39.

<sup>43</sup> Board of Taxation, *Quality and Effectiveness of the Non-Commercial Losses Legislation — Post-implementation Review* (2004) [1.13]–[1.14], <<http://www.taxboard.gov.au/content/CompletedReviewsAndConsultations.aspx>>.

<sup>44</sup> For example, under these rules the issue of whether a business is being carried on, a major area of uncertainty, still needs to be resolved.

<sup>45</sup> Board of Taxation, Post-implementation Review, above n 39, [1.2].

From the outset, the Board appears to have adopted a very limited review of div 35, as it stated in its report:<sup>46</sup>

[P]ost-implementation reviews are not intended to reopen debates about the merits of the policy underlying the legislation. Rather the intention is to gauge how effectively the legislation has been in delivering the Government's policy intent and to find out whether its implementation can be improved.

As noted above, the *Ralph Review*, originally contemplated a broader post implementation review process for the *proposed Board*.<sup>47</sup> Further, the *Ralph Review* considered the *proposed Board's* role should have been to be the guardian of the *Charter of Business Taxation* (as discussed previously)<sup>48</sup> if it is to consider the tax objectives and tax design principles.

It is also apparent that the Board's consultation process was constrained, as the Board only received 24 public submissions despite the 100,000 plus taxpayers having deferred losses under div 35.<sup>49</sup> Not surprisingly, the submissions to the Board included a number of strong views concerning the structural problems in the NCL rules which fail to limit loss deductions for many hobby/lifestyle activities<sup>50</sup> and the way the rules defer deductions for genuine business losses.<sup>51</sup> The submissions also pointed to the complexity of the NCL rules.<sup>52</sup> The Board, though, declined to respond directly to these concerns because it had excluded policy issues from the scope of its examination.<sup>53</sup> This is considered to be a weakness in the Board's mandated review process and inconsistent with the *Ralph Review's* recommendation.<sup>54</sup>

The Board<sup>55</sup> observed that the business and industry submissions to its examination,<sup>56</sup> and the BDO Kendalls' survey results,<sup>57</sup> reflected a strong perception that div 35 did not take sufficient account of actual taxpayer circumstances and commercial practices. The Board noted that there existed confusion as to what types of businesses could be

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<sup>46</sup> Ibid [1.3].

<sup>47</sup> *A Tax System Redesigned*, above n 1, 102-03.

<sup>48</sup> Ibid 119.

<sup>49</sup> Board of Taxation, Post-implementation Review, [1.13]-[1.14], <<http://www.taxboard.gov.au/content/CompletedReviewsAndConsultations.aspx>>.

<sup>50</sup> Taxation Institute of Australia, Submission to the Board of Taxation Post-implementation Review, above n 39, 2; Taxpayers Australia, Submission to the Board of Taxation Post-implementation Review, above n 39, 6.

<sup>51</sup> Taxation Institute of Australia, Submission to the Board of Taxation Post-implementation Review, above n 39, 1.

<sup>52</sup> Ibid, 5. Institute of Chartered Accountants, Submission to the Board of Taxation Post-implementation Review, above n 39, 2-5.

<sup>53</sup> Board of Taxation, Post-implementation Review, above n 43, [1.15]-[1.17].

<sup>54</sup> As noted above, this is out of step with the *Ralph Review's* view of the post implementation process, see *A Tax System Redesigned*, above n 1, 17.

<sup>55</sup> Ibid 1.19.

<sup>56</sup> Board of Taxation Post-implementation Review, Submissions Received, above n 39.

<sup>57</sup> Board of Taxation Post-implementation Review, BDO Kendall Report, above n 43.

grouped and what sorts of activities constituted a professional arts business.<sup>58</sup> Further, they uncovered an anomaly, namely provisions failed to take into account the value of depreciated plant for taxpayers in the STS/SBE regimes.<sup>59</sup> Nevertheless, the Board concluded:<sup>60</sup>

the intent of the legislation was delivered in a manner that was easily understood without any substantive unintended consequences or significant compliance burdens on the community. The ATO's implementation strategy was a significant factor in the smooth implementation of this legislation.

The Board made the following five recommendations, designed to alleviate the concerns raised in the consultation phase:<sup>61</sup>

Recommendation 1	The Board recommends that STS assets (excluding cars, motor cycles and similar vehicles) be counted towards the 'other assets' test in Division 35.
Recommendation 2	The Board recommends that the application form for the Commissioner's discretion and taxation rulings include additional non-primary production examples to make clear that these business activities can also qualify for the discretion.
Recommendation 3	The Board recommends that the assessment process for the Commissioner's discretion take more account of the intricacies of a particular business activity rather than relying on broad industry precedents.
Recommendation 4	The Board recommends that the ATO considers issuing additional guidance material on grouping, incorporating examples at the margin, to clarify the types of activities that may be grouped.
Recommendation 5	The Board recommends that the ATO should expedite a public ruling on what constitutes a professional arts business.

The Australian Taxation Office ('ATO') promptly acted upon recommendations 2, 3, 4, and 5 and provided an administrative solution. The federal government, though, declined to permit the former STS depreciating assets to be included in the Other Assets test in s 35-45, reasoning that desegregation of a former STS pool for div 35 would be inconsistent with the approach taken for STS taxpayers and div 328.<sup>62</sup> However, this

<sup>58</sup> Ibid. For example what constitutes a professional arts business was in dispute in *Pedley v Federal Commissioner of Taxation* AATA 108; 2006 ATC 2064; (2006) 62 ATR 1014. In this case the AAT held that the taxpayer was engaged in an installation arts business.

<sup>59</sup> Board of Taxation Post-implementation Review, above n 43, [1.19].

<sup>60</sup> Ibid [1.18].

<sup>61</sup> Board of Taxation 'Post-implementation Review of the Non-commercial Losses Legislation' (Press Release No. 14, 27 April 2005) 4, <[http://www.taxboard.gov.au/content/Content.aspx?doc=publications\\_and\\_media/media\\_releases/014.htm&pageid=008](http://www.taxboard.gov.au/content/Content.aspx?doc=publications_and_media/media_releases/014.htm&pageid=008)>

<sup>62</sup> Ibid.

means that STS taxpayers are dealt with more harshly under div 35. This appears to be out of step with the goal of the STS to reduce the effective tax burden for small business,<sup>63</sup> and with the *Ralph Review's* recommendation for an integrated tax code.<sup>64</sup>

Whilst the Board asserted that the NCL provisions improve simplicity and reduce uncertainty,<sup>65</sup> the analysis of commentators and professional and government bodies (noted above) shows that this is not the case. The provisions are not always expressed in a clear, simple, comprehensible, and workable manner. Further, as discussed previously, these measures contain significant inequities and inefficiencies. For the Board to be able to conduct a thorough examination of the NCL reforms it must be given the scope and resources to review the effectiveness of the reforms against their policy objectives and the four key tax policy criteria.

## 2 *Ad hoc Amendment 2002: Amendment to the Commissioners discretion*

Division 35 was amended in 2002 to correct a technical defect under s 35-55(2). Previously, s 35-55(2) prevented the exercise of the Commissioner's discretion after the first occasion on which the business activity produced a profit or met one of the tests, even for earlier income years, even though the period that was commercially viable was still in course.<sup>66</sup> Thus, the discretion could not be exercised in income years in which losses arose following a one-off profit made from thinning out a plantation and selling the cut timber. Consequently, s 35-5(2) was amended to ensure the Commissioner's discretion could be exercised for any income year or years within the period that is commercially viable for the business activity.

## 3 *Consequential Amendment 2006: Business Related Costs*

In 2006 the government introduced a provision to broaden the operation of 'blackhole deduction' provisions. Section 40-880 was amended to provide deductions for certain business capital expenditure incurred from 1 July 2005 but not recognised in some way elsewhere in the tax law.<sup>67</sup> Consequently, div 35 was amended to take into account certain new capital deductions for pre- and post-business expenditures deductible under the amended s 40-880. On this basis the pre- and post-business expenditures deductible under s 40-880 will not be generally prevented from being deducted against other assessable income where the pre- and post-business expenditures relate to a business activity that satisfies one of the tests in div 35, or where the Commissioner exercises a discretion.<sup>68</sup>

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<sup>63</sup> Explanatory Memorandum, New Business Tax System (Simplified Tax System) Bill 2000, [1.5]–[1.7].

<sup>64</sup> *A Tax System Redesigned*, above n 1, 129.

<sup>65</sup> Board of Taxation Post-Implementation Review, above n 43, [1.18].

<sup>66</sup> Explanatory Memorandum, Taxation Laws Amendment Bill (No. 1) 2002, [1.7].

<sup>67</sup> Explanatory Memorandum, Tax Laws Amendment (2006 Measures No. 1) Bill 2006, [2.9].

<sup>68</sup> *Ibid* [2.5].

#### 4 *Adhoc Review 2009: High Income Earners Limitation; Investment Allowances*

Notwithstanding the serious flaws in the NCL rules (identified above) it was not until May 2009, that the Labor government moved to partially address these inequities. The federal government further restricted the deductions for NCL<sup>69</sup> to prevent around 11,000 high wealth individuals with taxable incomes over \$250,000 from claiming tax deductions for NCL business activities against their other income. The government released an exposure draft of the proposed legislation for public consultation on 26 June 2009 with the consultation period closing on 26 July 2009.<sup>70</sup> The EM for the Bill as introduced summarised the feedback received as follows:<sup>71</sup>

2.10 Submissions raised concerns around the process for applying to the Commissioner, and the evidentiary burden for taxpayers applying for a discretion, including what constituted 'objective evidence'. The exposure draft has been amended to require applications to be made in an approved form. The form will help the taxpayer work out what information is required to be provided to the Commissioner to assess whether or not to exercise his or her discretion.

2.11 Submissions also raised concerns about the continued status of discretions obtained prior to the changes in this Bill; particularly in relation to 'managed investment schemes'. Transitional provisions now ensure that all previous discretions granted by the Commissioner will continue to apply.

2.12 Consultations also raised the issue of investment allowances under Division 41 of the ITAA 1997 being quarantined to a business activity that is otherwise profitable, but because of the investment allowances makes a tax loss. The exposure draft has been amended to carve-out those investment allowances for owners of otherwise profitable businesses.

Thus, the public consultation proved to be effective as it ensured that discretions granted prior to these changes in the *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009* were honoured, and ensured that the new div 41 dealing with capital allowances was consistent with the NCL rules.

As proposed, from 1 July 2009, taxpayers with adjusted taxable incomes of over \$250,000 have not been able to deduct those expenses against income from the (non-commercial) business activity that results in a loss.<sup>72</sup> It was estimated that this reform would result in the following revenue savings:<sup>73</sup>

2009-10	2010-11	2011-12	2012-13
Nil	\$330m	\$240m	\$130m

<sup>69</sup> Commonwealth Treasury, 'Improving Fairness and Integrity in the Tax System', (Press Release No 067, 12 May 2009), <<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/067.htm&pageID=003&min=wms&Year=&DocType>>.

<sup>70</sup> Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, [2.9].

<sup>71</sup> Ibid.

<sup>72</sup> ITAA 1997 s 35-10(1)(a), s 35-10(2A), s 35-10(2E), 35-55(1).

<sup>73</sup> Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, General outline and financial impact.

Whilst this reform substantially reduces the scope for high income taxpayers to avoid the NCL limitations, there will be many taxpayers earning less than \$250,000 that will be able to avoid div 35. Other taxpayers may be able to manipulate their taxable income so as to fall under this threshold.

#### **IV POST IMPLEMENTATION REVIEWS OF THE STS**

##### ***A Overview of the Simplified Tax System Legislation***

The STS regime commenced on 1 July 2001. Under the STS regime, a small business taxpayer first needed to work out on an annual basis whether they were eligible to join or to remain in the STS. The taxpayer must have carried on a business during the year to enter the STS,<sup>74</sup> thus passive investors were excluded. The second requirement stipulated that the year's average turnover of a STS taxpayer and its grouped entities must have been less than \$1,000,000 (net of GST credits and decreasing adjustments).<sup>75</sup> Thirdly, the STS required that the total adjustable values<sup>76</sup> of depreciating assets<sup>77</sup> held at year end by the STS taxpayer and its grouped entities must have been less than \$3,000,000.<sup>78</sup>

The STS originally comprised a package of four elements, involving 'simplified' accounting methods,<sup>79</sup> prepaid expenses,<sup>80</sup> capital allowances,<sup>81</sup> and trading stock.<sup>82</sup> The STS provided a mandatory unique 'cash basis' style accounting method for small business income and expenses which commenced on 1 July 2001.<sup>83</sup> Under this method, small business would account for their income and expenses on a cash basis (rather than accruals).<sup>84</sup> Also, under the STS, prepaid expenses were immediately deductible for STS taxpayers where the period of the benefit of the prepayment was 12 months or less.<sup>85</sup> Where the prepayments did not meet this requirement a pro rata deduction for the prepayment was available over the lesser of eligible service period or 10 years.

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<sup>74</sup> ITAA 1997 former s 328-365(1)(a).

<sup>75</sup> ITAA 1997, former s 328-365(1)(b). This requirement contained grouping rules that prevented large businesses from splitting or restructuring into numerous entities so they were eligible to join the STS.

<sup>76</sup> ITAA 1997, s 40-85.

<sup>77</sup> ITAA 1997, s 40-30.

<sup>78</sup> ITAA 1997, former s 328-365(1)(c). The limit on the total value of depreciating assets that an entity and its grouped entities could have at the end of an income year ensured that large entities with low turnovers in early years of operation but with large investments in capital assets were not eligible to enter the STS.

<sup>79</sup> ITAA 1997, former sub-div 328-C. Note that taxpayers who joined the STS prior to 30 June 2005 can still use the cash accounting system.

<sup>80</sup> ITAA 1936 s 82KZM.

<sup>81</sup> ITAA 1997 sub-div 328-D.

<sup>82</sup> ITAA 1997 sub-div 328-E.

<sup>83</sup> The cash accounting method was abolished prior to the advent of the SBE regime on 30 June 2005.

<sup>84</sup> ITAA 1997, former sub-div 328-C. Prior to the STS, the income tax timing rules for the 'derivation' of ordinary business income and the 'incurring' of deductions for small business broadly equated with the accruals accounting system.

<sup>85</sup> ITAA 1936 s 82KZM(1)(aa). This replaced the former 13 month prepayment rule.

Special depreciation rules were provided for STS taxpayers.<sup>86</sup> STS depreciating assets were depreciated at accelerated depreciation rates by using a pool as a single depreciating asset.<sup>87</sup> There were two types of pools: a general STS pool for depreciating assets with an effective life of less than 25 years<sup>88</sup> and a long life STS pool for depreciating assets with an effective life of 25 years or more.<sup>89</sup> An immediate write-off applied to depreciating assets costing less than \$1,000.<sup>90</sup>

Under the STS trading stock regime, where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year was less than \$5,000, an STS taxpayer did not have to value each item of trading stock at year end and account for any changes in the value of trading stock.<sup>91</sup>

### **B Rationale and Reality**

The tax policy rationale for the STS, as set out in the EM, principally focused on its simplification benefits for record keeping and reporting for the small business sector.<sup>92</sup> The EM provided little on the specific impact of the STS system on economic efficiency<sup>93</sup> and ignored its impact on equity. The STS concessions clearly breached the fiscal adequacy as anticipated by the EM's tax revenue loss estimates.<sup>94</sup> This measure was intended to be a tax expenditure.

However, commentators and professional and government bodies found that the STS breached the key tax policy criteria (like the NCL rules).<sup>95</sup> The STS added another layer

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<sup>86</sup> ITAA 1997, former sub-div 328-D. Outside of the STS, a uniform capital allowance system applied. Unlike the STS depreciation regime, the uniform depreciation provisions are based on the effective life of depreciating assets and broadly reflect proper financial accounting practice.

<sup>87</sup> ITAA 1997, former s 328-185(1).

<sup>88</sup> ITAA 1997, former s 328-185(2)(a).

<sup>89</sup> ITAA 1997, former s 328-185(2)(b).

<sup>90</sup> ITAA 1997, former s 328-180(1).

<sup>91</sup> ITAA 1997, former s 328-285(1). Prior to the STS, small business were required to fully account for trading stock in their income tax returns in accordance with ITAA 1997 div 70.

<sup>92</sup> Explanatory Memorandum, Simplified Tax System Bill 2001, [1.5]-[1.7], [4.11]-[4.12], [7.9], [8.19]. The EM observed that new STS cash accounting rules would benefit small business as they would minimise compliance costs for STS taxpayers because, for tax purposes, they will not be required to recognise sales for which payment has not been received, and for deductions side, they will not be required to recognise expenses that they have not paid. Further, the EM stated that the new STS prepayment rules would strengthen the rules for prepaid expenses and provide simplification benefits. Additionally, the STS capital allowances rules were to provide compliance cost savings by removing or reducing the need to maintain individual asset depreciation schedules and make separate calculations for each asset for deduction and balancing charge purposes. Also, the trading stock treatment under the STS would reduce compliance costs by requiring that changes in trading stock only be brought to account in certain limited circumstances.

<sup>93</sup> Ibid [8.34].

<sup>94</sup> Ibid [8.32]-[8.33].

<sup>95</sup> H Hodgson, 'Small business simplification – yet again?' (2007) 11 *The Tax Specialist* 140; R Douglas, 'Tax Simplification for Small to Medium Business' (Paper presented at the Taxation Institute of Australia New South Wales State Convention May 2000) 8, 10; M Hine, 'Small Business Tax System (STS)' (Paper presented at the Taxation Institute of Australia, Western Australian State Convention May 2001) 24, 29; I Snook, 'Simplified Tax System: A Favourable Current, a Riptide or Just Plain Dead Calm?' (Paper Presented

*Footnote continues over page*

of rules on top of an already complex income tax system. Division 328 also failed to provide an appropriate universal definition of a 'small business'.<sup>96</sup> Further, the design of the STS was intricate. For example, the STS contained complicated eligibility rules (especially for groups).<sup>97</sup> The inflexibility of the STS was demonstrated by the mandatory application of the STS cash accounting, prepayment, and capital allowances concessions. The STS cash accounting basis created a number of problems for many small businesses that utilised accruals accounting, and they obtained little benefit from the concessions.<sup>98</sup> Also, the STS cash accounting, capital allowance, and trading stock provisions all contained highly elaborate rules.<sup>99</sup>

The STS concessions were unfair since they favoured a minority of small businesses over other taxpayers. The concessions mainly benefited small businesses with significant levels of depreciating assets<sup>100</sup> and this was inefficient.<sup>101</sup> Further, the concessions only provided a timing benefit from the temporary deferral of income tax.<sup>102</sup> Reflecting the hurried implementation of the STS, a number of inconsistencies arose as the STS did not always interact appropriately with the capital allowances system, capital gains tax regime, and the dictionary to the legislation. Eventually these matters were addressed by amendment.

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at the Taxation Institute of Australia, South Australian State Convention May 2001) 75, 75; B Bondfield, 'A Year on in the Simplified Tax System: has the reality matched the rhetoric?' (2002) 37 *Taxation in Australia* 253; P Kenny, 'A Simplified Tax System for Small Business: Or, Just Another Tax Preference?' (2002) 6 *The Tax Specialist* 36, 39; J Tretola, (2007) 'The Simplified Tax System — Has It Simplified Tax At All And, If So, Should It Be Extended?' (2007) 17 *Revenue Law Journal* 4; M McKerchar, 'Is the Simplified Tax System Simple?' (2007) 10 *The Tax Specialist* 140, 141–142; M Pizzacalla, 'Australia's SME identity crisis' (2007) 22 *Australian Tax Forum* 19; Samarkovski Freudenberg above n 39; M Burton, 'The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?' (2006) 21 *Australian Tax Forum* 71; CPA Australia, *Small Business Survey: Compliance Burden* (2006); Taxation Institute: Submission to the Taskforce on Reducing the Regulatory Burden on Business, 28 November 2005, <[www.regulationtaskforce.gov.au/submissions/sub078.rtf](http://www.regulationtaskforce.gov.au/submissions/sub078.rtf)>; Institute of Chartered Accountants: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005; G Shaw, 'Changing to the Simplified Tax System' (2005) *Taxpayers Australia* 7 November 2005, 154; M Dirkis and B Bondfield, 'The RBT ANTS Bite: Small Business the First Casualty' (2004) 19 *Australian Tax Forum* 107; G Walker, 'The Simplified Tax System — the Good, the Bad and the Ugly' (2003) 7,20 *CCH Tax Week* 95; L Wolfers and J Miller, 'The Simplified Tax System: Is this Government Speak for "Complex"?' (2001) 35 *Taxation in Australia* 374; F Martin, 'STS Implications' (2001) 36 *Taxation in Australia* 245; ICAA Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000; G Cooper, 'The Government Response to the Ralph Report: An Initial Overview' (1999) 34 *Taxation in Australia* 232.

<sup>96</sup> ITAA 1997, former s 328-365(1)(b).

<sup>97</sup> ITAA 1997, former sub-divs 328-F and 328-G.

<sup>98</sup> Douglas above n 96, 11; Snook above n 96, 77–78; Bondfield above n 96, 332–34; Kenny 'A Simplified Tax System for Small Business' above n 96, 37; Tretola above n 96, 14; Wolfers Miller above n 96, 376.

<sup>99</sup> ITAA 1997, former sub-divs 328-C, 328-D, 328-E.

<sup>100</sup> *A Tax System Redesigned*, above n 1, 721.

<sup>101</sup> The STS discriminates against low income, small business taxpayers such as 'start up' businesses since they face a zero or low marginal income tax rate. For such businesses, the value of a tax benefit under the STS concessions is negligible or nil. It is apparent from the *Ralph Review's* tax revenue modelling that the STS depreciation concessions provided the primary benefit to small business. Thus small businesses involved in capital intensive sectors of the economy such as the agriculture, forestry, fishing, mining, manufacturing, construction and transport sectors benefited. Other sectors such as retail and professional service providers obtained little benefit. See *A Tax System Redesigned*, above n 1, 721.

<sup>102</sup> ITAA 1997 former sub-divs 328-C, 328-D, 328-E; ITAA 1936, s 82KZM ITAA.



## ***C Post Implementation Reviews of the STS***

### ***1 Board of Taxation***

Over its six year life the STS did not prove to be very popular with small business<sup>103</sup> and was subject to significant and sustained levels of criticism by commentators and professional and government bodies (as noted previously). The Board, though, was not tasked with the post-implementation review of the STS. Such an outcome is out of step with the stated aim of the *Ralph Review's* recommendation that enacted tax preferences be periodically and systematically reviewed against their objectives.<sup>104</sup> This indicates that the Board operated under a restrictive terms of reference and was not appropriately funded to carry out such reviews.

It was only in December 2007, after the cessation of the STS, that the Board (upon the request of the Treasurer), completed a scoping study of small business tax compliance costs.<sup>105</sup> The Board was asked to identify the key factors that influence small business compliance costs and provide some guidance on the issues that should be considered in reducing compliance costs for small business.<sup>106</sup> As part of the review, the Board belatedly was able to examine the STS. Its conversations with tax agents indicated that many STS clients were ignorant of the existence of the STS.<sup>107</sup> The tax agents decided for their clients' whether they should elect to join.<sup>108</sup> The STS taxpayers that were aware of the STS could not determine whether the STS would benefit their business given its complexity.<sup>109</sup> The Board's consultations with tax agents further found that they were not generally supportive of the STS. The broad comments from tax agents were:<sup>110</sup>

- The initial STS requirement (until 2005) for businesses to use cash accounting was inconvenient and unpopular because tax agents were more accustomed to accrual accounting and some of their clients preferred up-front deductions for expenses that are incurred but not yet paid.
- Some tax agents perceived the benefits were too modest and only useful for small businesses that could benefit from accelerated depreciation.
- When it was introduced in 2002 many tax agents were still getting across the relatively new GST, so tax agents did not have the time to consider its merits.
- It was an all-or-nothing package and while some elements may have benefited particular small businesses, others may not.
- The various criteria and thresholds for entry increased compliance costs.

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<sup>103</sup> ATO Tax Practitioners Forum Issues Log (register n, A27), <[www.ato.gov.au/taxprofessionals/content.asp?doc+/content/39983.htm&page=165&H28\\_1](http://www.ato.gov.au/taxprofessionals/content.asp?doc+/content/39983.htm&page=165&H28_1)>. Only 14 per cent of small business had joined the STS in the year ended 30 June 2002.

<sup>104</sup> *A Tax System Redesigned*, above n 1, 275–76.

<sup>105</sup> Board of Taxation, *Study of Small Business Tax Compliance Costs, Report to the Treasurer* (2007), <[http://www.taxboard.gov.au/content/content.aspx?doc=reviews\\_and\\_consultations/small\\_business\\_tax\\_compliance\\_costs/default.htm&pageid=00](http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/small_business_tax_compliance_costs/default.htm&pageid=00)>.

<sup>106</sup> *Ibid.*

<sup>107</sup> *Ibid* 93.

<sup>108</sup> *Ibid.*

<sup>109</sup> *Ibid.*

<sup>110</sup> *Ibid.*

In reviewing the new Small Business Entities ('SBE') regime (that replaced the STS) the Board adopted a proactive stance. The Board asserted that 'a post-implementation review of the SBE regime in two to three years time may be useful.'<sup>111</sup>

## 2 *Consequential Amendment 2001: Research and development activities*

As a result of changes in the treatment of expenditure on depreciating assets used for research and development, the deductions for depreciating assets used in carrying on research and development activities were worked out under ITAA 1936 s 73BA from 1 July 2001 (ie separately from the STS).<sup>112</sup> As a consequence, the STS depreciation rules were amended to exclude a deduction for amounts in respect of depreciating assets used in carrying on research and development activities that were worked out under the new section.

## 3 *Ad hoc Amendment 2002: STS interaction with other provisions in the ITAA 1997*

A number of inconsistencies became clear, reflecting the hurried implementation of the STS. *Taxation Laws Amendment Act (No. 5) 2002* attempted to ensure that the STS capital allowances system operated as intended, and interacted appropriately with the capital allowances system, capital gains tax regime, and the dictionary to the legislation.

Note 2 of s 40-25(1) was amended to reflect the fact that an STS taxpayer both deducted and worked out the amount they could deduct, under div 328 (whilst s 40-25(1) provided a deduction equal to the decline in value of an asset that is held by a taxpayer during an income year).

Section 40-215 ensures that the cost of any depreciating assets for which a deduction is allowable under Division 40 is not reduced. Consequently an amendment was made to insert the words 'or Division 328' in s 40-215(1). This meant that the cost of a depreciating asset was not reduced by any deduction allowable under div 328.<sup>113</sup>

The capital gains tax rules<sup>114</sup> were amended to remove the reference to decline in value in relation to the STS. The STS does not refer 'to decline in value'. This ensured the terminology used is consistent.

The STS depreciation rules in s 328-175(6) were amended to allow a deduction to be claimed unless it was 'reasonably expected' that the depreciating asset would be predominantly leased in the future (rather than 'intended' to be leased). This would provide greater clarity since taxpayers would not always be in a position to know how a depreciating asset was intended to be used, and may have had difficulty in interpreting this provision.<sup>115</sup>

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<sup>111</sup> Ibid 94.

<sup>112</sup> Explanatory Memorandum, Taxation Laws Amendment (Research and Development) Bill 2001 [2.1]-[2.6].

<sup>113</sup> Explanatory Memorandum, Taxation Laws Amendment Bill (No. 5) 2002 [3.106].

<sup>114</sup> ITAA 1997 s 104-235(4)(b).

<sup>115</sup> Explanatory Memorandum, Taxation Laws Amendment Bill (No. 5) 2002 [3.108].

The STS depreciating asset rules were further amended to allow a deduction for a cost addition (improvements) of less than \$1,000 for a low cost asset in the year of purchase.<sup>116</sup> If the cost of the addition is \$1,000 or more, including subsequent cost additions of any value, both the cost addition and the underlying low cost asset are added to the general STS pool.<sup>117</sup> Further, s 328-180(2) also allows a cost addition of \$1,000 or more for a low cost asset, and any subsequent cost additions, regardless of their cost, to be added to a pool, even after the STS taxpayer has left the STS.

To correct a technical error, s 328-225(3) was amended to omit the words 'the end of' and substitute 'the beginning of'. This ensured that, in determining the adjustment to the opening pool balance where there has been a change in the business use of an asset, only those cost additions made to the asset until the beginning of the income year in which the adjustment applies were included in the asset value.<sup>118</sup>

The amendments also included belated updates to the definitions in s 995-1 for the STS in respect of the capital allowances definition (to include the STS) and for defining expenditure on in-house software (to include the STS).<sup>119</sup>

#### 4 *Ad hoc Amendment 2004: STS roll-over relief*

It appears that, in response to a number of concerns about the STS, the federal government implemented a series of amendments to the STS to make it more attractive to small business. First, an anomaly for a 'simpler' system for small business was fixed. The STS capital allowance rules in sub-div 328-D did not originally provide for any roll-over relief for depreciating assets (unlike div 40 that was available for non-STS partnership taxpayers). To encourage the uptake of the STS<sup>120</sup> optional roll-over relief was provided.<sup>121</sup> Roll-over relief was only available where the entities both before and after the change are partnerships. Roll-over relief for partnerships in the STS ensured that the transferor taxpayer ignored the balancing adjustment amount at the time of the partnership change so that no amount was included in its assessable income.

#### 5 *Ad hoc Amendment 2005: STS accounting method; Further STS roll-over relief; the STS entrepreneurs discount*

The mandatory STS cash accounting basis created a number of problems for many small businesses that utilised accruals accounting and who obtained little benefit from the

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<sup>116</sup> ITAA 1997 s 328-180(2).

<sup>117</sup> ITAA 1997 s 328-180(2); Explanatory Memorandum Taxation Laws Amendment Bill (No. 5) 2002 [3.109].

<sup>118</sup> Ibid [3.111].

<sup>119</sup> Ibid [3.112]–[3.113].

<sup>120</sup> Explanatory Memorandum, Taxation Laws Amendment Bill (No. 2) 2004, [7.5] states 'Roll-over relief is not currently available for reconstitutions of partnerships operating under the STS (ie STS partnerships), deterring some taxpayers from joining the STS. This measure will allow optional roll-over relief for STS partnerships subject to certain conditions.'

<sup>121</sup> ITAA 1997, former s 328-240; ss 328-243, 328-245.

concessions.<sup>122</sup> Consequently, the cash accounting system was abandoned from 1 July 2005.<sup>123</sup> As the EM stated, the 'removal of the cash accounting requirement will enable more businesses to access the benefits of the STS whilst calculating their taxable income using the most appropriate method applicable to their circumstances.'<sup>124</sup> It took four years, though, to fix this obvious flaw in the STS.

In another anomaly for a 'simplified' system, the STS provided roll-over relief that was only available where the entities both before and after the change were partnerships. Thus optional roll-over relief was extended under subsection 40-340(3) to balancing adjustment events occurring in relation to depreciating assets in a STS pool under s 40-295(2). This would occur where a change occurs in the holding of, or in interests of entities in, the asset; at least one of the entities that had an interest in the asset before the change has an interest in the asset after the change; and the asset was a partnership asset either before or as a result of the change.<sup>125</sup>

An entrepreneurs' tax offset (25 per cent) was introduced in respect of the income tax payable on business income for STS taxpayers that had an annual turnover of \$75,000 or less. Where STS turnover was greater than \$50,000 the offset phased out so that the offset ceases once STS turnover reaches \$75,000. The EM provided the following rationale:<sup>126</sup>

In the 2004 election policy statement Promoting an Enterprise Culture, the Government announced a number of measures designed to foster the entrepreneurial spirit of small businesses. The Government stated that it would provide further incentive and encouragement to small businesses - particularly those that set up and operate from home - through the introduction of a tax offset for entrepreneurs. This proposal is targeted at very small, micro and home-based businesses that are in the STS.

However, this measure was estimated to cost the revenue \$400 million in 2006-07 and \$390 million in 2007-08.<sup>127</sup> Rather than fixing the flaws in the STS this measure created more inequities and inefficiencies since the offset mainly benefited STS taxpayers with higher turnovers near the \$75,000 cut off that had few deductions. Other taxpayers received little or no benefit from this measure. Further, the ATO incurred additional administration costs in managing the new STS concession. Overall, this measure appears

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<sup>122</sup> Douglas, above n 96, 11; Snook, above n 96, 77-78; Bondfield, above n 96, 332-34; Kenny 'A Simplified Tax System for Small Business', above n 96, 37; Tretola, above n 96, 14; Wolfers Miller, above n 96, 376.

<sup>123</sup> *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Sch 2. STS taxpayers that joined before 1 July 2005, though, could continue to use the cash accounting basis. See *Income Tax Transitional Provisions Act 1997* (ITTPA 1997) s 328-100.

<sup>124</sup> Explanatory Memorandum, *Tax Laws Amendment (2004 Measures No. 7) Bill 2005*, General outline and financial impact.

<sup>125</sup> Ibid: 'This amendment ensures that roll-over relief is available if there is a change in business structure involving a partnership. For example, if a sole trader takes on a new partner, roll-over relief will be available to defer any adjustment to taxable income resulting from that balancing adjustment event. Likewise, if a partner leaves a partnership and the remaining partner carries on as a sole trader, roll-over relief will be available.'

<sup>126</sup> Ibid.

<sup>127</sup> Ibid.

to have breached all of the tax policy criteria. This appears to have been a vote gathering exercise designed for the 2004 election.

## 6 *The Banks Taskforce: 2007 Small Business Entities regime replaces the STS*

On 12 October 2005, the former Coalition government established a taskforce chaired by Gary Banks ('*Banks Taskforce*') to reduce the regulatory burden on small business.<sup>128</sup> The *Banks Taskforce's* report *Rethinking Regulation* was provided to the federal government on 31 January 2006.<sup>129</sup> The submissions to the *Banks Taskforce* called for a consistent definition of small business.<sup>130</sup> The *Banks Taskforce* consequently found that there was a need to harmonise taxation law definitions and recommended that the definition of a small business be aligned or rationalised.<sup>131</sup>

After some delay, on 1 July 2007, the federal government renamed and modified the STS in div 328 as part of the new 'Small Business Entities' ('SBE') regime in order to simplify the various small business concessions.<sup>132</sup> Under the SBE rules the former STS depreciation, prepayment, and trading stock income tax accounting concessions were retained with some minor modifications. The new SBE definition of a small business was also aligned with a number of other small business concessions.<sup>133</sup>

The SBE test provided a new measure for determining what constitutes a small business.<sup>134</sup> From 1 July 2007, SBEs have the choice to apply any of the SBE concessions since they are no longer compulsory,<sup>135</sup> unlike most of the former STS concessions.<sup>136</sup> Under the SBE rules there is no need to lodge an election with the ATO to access the concessions.<sup>137</sup> The former \$1 million STS average turnover threshold<sup>138</sup> was replaced with a \$2 million aggregate turnover threshold<sup>139</sup> and the former STS \$3 million depreciating assets test was abolished.<sup>140</sup> The removal of the depreciating asset limit, though, structurally damaged the integrity of the SBE definition of a small business. Under this SBE definition large and medium sized businesses (such as mining companies) will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold.

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<sup>128</sup> Banks Taskforce, above n 18.

<sup>129</sup> Ibid.

<sup>130</sup> Ibid.

<sup>131</sup> Ibid 169–170, Recommendation 5.43.

<sup>132</sup> *Tax Laws Amendment (Small Business) Act 2007*.

<sup>133</sup> ITAA 1997 sub-div 328-C.

<sup>134</sup> ITAA 1997 s 328-110(1).

<sup>135</sup> Ibid.

<sup>136</sup> ITAA 1997 former sub-divs 328-C, 328-D; ITAA 1936 s 82KZM.

<sup>137</sup> ITAA 1997 sub-divs 328-D, 328-E, ITAA 1936 s 82KZM.

<sup>138</sup> ITAA 1997 former s 328-365(1)(b).

<sup>139</sup> ITAA 1997 s 328-110(1)(b).

<sup>140</sup> ITAA 1997 s 328-110(1).

The SBE test now applies to the following concessions:<sup>141</sup>

- Simpler depreciation rules: ITAA 1997 sub-div 328-D;
- Simplified trading stock rules: ITAA 1997 sub-div 328-E;
- Deducting certain prepaid business expenses immediately: ITAA 1936 ss 82KZM and 82KZMD;
- CGT 15-year asset exemption: ITAA 1997 sub-div 152-B;
- CGT 50% active asset reduction: ITAA 1997 sub-div 152-C;
- CGT retirement exemption: ITAA 1997 sub-div 152-D;
- CGT roll-over: ITAA 1997 sub-div 152-E;
- Accounting for GST on a cash basis: *A New Tax System (Goods and Services Tax) Act 1999* ('GST Act') s 29-40;
- Annual apportionment of input tax credits for acquisitions and importations that are partly creditable: GST Act s 131-5;
- Paying GST by quarterly instalments: GST Act s 162-5;
- FBT car parking exemption: *Fringe Benefits Tax Assessment Act 1986* s 58GA;
- PAYG instalments based on GDP-adjusted notional tax: *Taxation Administration Act 1953* sch 1 s 45-130.

Consequential amendments were made to the above provisions to introduce the new term of SBE and to replace all former small business references (such as 'STS taxpayers'). However, some of the above concessions impose alternative tests to the SBE requirements that allow non-SBEs to access the concessions. This undermines the simplicity benefit that could have been achieved from having a single definition of small business.<sup>142</sup> For example, the small business capital gains tax concessions utilise an alternative \$6 million net assets test.<sup>143</sup> This breaches the *Ralph Review's* recommendation of an integrated tax code having 'a common dictionary to ensure consistency and greater standardisation of concepts across the Code'.<sup>144</sup>

The former STS entry and exit rules in sub-divs 328-F and 328-G were repealed as they are unnecessary under the fully optional SBE regime.<sup>145</sup> However, complex transitional rules were introduced to cater for the move from the STS to the SBE regime.<sup>146</sup>

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<sup>141</sup> ITAA 1997 s 328-10(1).

<sup>142</sup> Hodgson, above n 96, 140.

<sup>143</sup> ITAA 1997 s 152-15.

<sup>144</sup> *A Tax System Redesigned* above n 1, 129.

<sup>145</sup> Explanatory Memorandum Tax Laws Amendment (Small Business) Bill 2007 [4.33].

<sup>146</sup> *Tax Laws Amendment (Small Business) Act 2007*, 49-56.

## V CONCLUSION

Fast tracking of large scale tax reform such as the *Ralph Review* reforms means that policy proposals and objectives may well be inappropriately conceived and the ensuing legislation may have substantial design deficiencies. Thus, there is a need for effective post implementation review processes.

This analysis illustrates the shortcomings of the ad hoc post implementation amendment and review processes for these enacted *Ralph Review reforms*. The two *Ralph Review* reforms examined, the NCL regime and STS, both contained significant flaws, yet these were not addressed in a timely and effective fashion. It took nine years before action was taken to address some of the problems with the NCL rules and six years to address some of the issues with the STS. The review processes were limited in scope, under resourced and they did not fully address the underlying policy flaws. The Board's review of the NCL regime was too narrow and the STS was not subject to a formal review but to a series of ad hoc amendments.

One of the key lessons to emerge from such fast tracking of large scale tax reform is that enacted tax reforms need to be subject to a timely and thorough post-implementation review process by an adequately funded independent body (perhaps 2-3 years after implementation).<sup>147</sup> This process must assess the tax reforms having regard to the generally accepted tax policy criteria.<sup>148</sup> An effective post implementation review process also requires extensive consultation and should be ongoing. The views of the general community, academic, and professional commentators and of professional and government bodies, must be regarded in assessing how well the policy goals are met.

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<sup>147</sup> *A Tax System Redesigned* above n 1, 275–76. As the ignored *Ralph Review* recommendation asserted, enacted tax preferences (such as those contained in the NCL rules) should be periodically and systematically reviewed against their objectives.

<sup>148</sup> Economic efficiency, equity, simplicity and fiscal adequacy. Alm, above n 6, 117.





**PROCEDURAL JUSTICE AND AUDIT-QUERY EXPERIENCES OF SMALL BUSINESSES AND TAX AGENTS**

SUE YONG\*

**ABSTRACT**

Accounting records of many small businesses are kept predominantly for the use of their lenders and for the tax authorities. Tax authorities use audits to monitor compliance by taxpayers. This paper aims to discuss the tax audit-query experiences of 36 small business owners in Auckland, New Zealand, from 2006 to 2010 and to assess how these impact on their tax perceptions by using a procedural justice framework. As part of the triangulation process, the accounts of the small business owners were verified by 15 business experts and eight tax agents. Policy makers should pay attention to the tax perceptions of small businesses as these affect voluntary compliance. Tax authorities should adopt fair procedures when interacting with small business owners to encourage cooperation. Cooperation from this taxpayer group could help to reduce its currently high non-compliance statistics relative to the wage and salary earners group.

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## I INTRODUCTION

Micro and small businesses have fewer external reporting requirements compared to those of larger businesses. In New Zealand, the *Financial Reporting Act 1993* and the *Financial Reporting Amendment Act 2006* require reporting entities such as issuers, overseas companies, companies with subsidiaries, and 'large' businesses to file and register their audited financial statements with the Companies Office.<sup>1</sup> 'Large' businesses are those which satisfy two of these criteria: they have total assets greater than NZD10 million; they have turnover of more than NZD20 million; and they have more than 50 full time employees.

Similarly, in Australia, the *Corporations Act 2001* requires disclosing entities, such as listed companies, registered managed investment schemes, unlisted public companies and large proprietary companies to lodge half yearly and annual audited statements with the Australian Securities and Investments Commission (ASIC).<sup>2</sup> 'Large' proprietary companies are those which satisfy two of these three criteria: they have gross operating revenue of AUD10 million or more; they have gross assets of AUD5 million or more; and they have 50 or more employees (full time or part time is not specified).

In the European Union, small businesses are defined as those entities with turnover of less than €10 million (equivalent to NZD15.8 million or AUD12.5 million), and which have up to 100 employees.<sup>3</sup> However in Australia and New Zealand, small businesses are those entities with less than 20 employees.<sup>4</sup> As most small businesses do not fall within the reporting/disclosing entity or 'large' company reporting requirements, formal reporting of their business transactions is undertaken largely to satisfy tax obligations<sup>5</sup> and/or to prove their creditworthiness.<sup>6</sup> Since small businesses are not required to submit audited financial statements to government agencies, audits, where applicable, are mostly performed by tax authorities such as the New Zealand Inland Revenue Department (IRD) or the Australian Taxation Office (ATO).

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<sup>1</sup> See New Zealand Companies Office, *New Zealand Companies* (2012) <<http://www.business.govt.nz/companies/learn-about/updates/new-zealand-companies>>.

<sup>2</sup> See ASIC, *Corporations Act Entities with Financial Reporting Obligations* (2008) <[http://www.asic.gov.au/asic/pdflib.nsf/add907be1c708f42ca256aca0007f465/145b2d613d3163f1ca2574430000d28b/\\$FILE/Corporations Act entities with financial reporting obligations 1.pdf](http://www.asic.gov.au/asic/pdflib.nsf/add907be1c708f42ca256aca0007f465/145b2d613d3163f1ca2574430000d28b/$FILE/Corporations%20Act%20entities%20with%20financial%20reporting%20obligations%201.pdf)>.

<sup>3</sup> European Commission Enterprise and Industry, *Small and medium-sized enterprises (SMEs): What is an SME?* (2012) <[http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index\\_en.htm](http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm)>.

<sup>4</sup> Australian Bureau of Statistics, *Australian Small Business Operators — Findings from the 2005 and 2006 Characteristics of Small Business Surveys, 2005–06* (2005) <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/8127.0>>; Ministry of Economic Development, *SMEs in New Zealand: Structure and Dynamics 2009* (2009).

<sup>5</sup> See suggestions for record keeping for small businesses in New Zealand Companies Office, above n 1.

<sup>6</sup> Richard McMahon and Leslie Davies, 'Financial Reporting and Analysis Practices in Small Enterprises: The Association with Growth Rate and Financial Performance' (1994) 32(1) *Journal of Small Business Management* 9.

Audits have historically been used by tax authorities as deterrents for tax cheating,<sup>7</sup> based on the economic self interest approach,<sup>8</sup> whereby individuals are assumed to be utility maximisers.<sup>9</sup> Taxpayers are assumed to cheat on taxes when they assess there are low risks of being caught relative to the benefits of cheating.<sup>10</sup> Some authors suggest that deterrence-based strategies can sometimes be counterproductive,<sup>11</sup> and can produce 'likelihood of non-compliance'.<sup>12</sup>

As an alternative to the deterrence-based strategy, this paper uses the procedural justice framework as a theoretical lens to explain how small business taxpayers might behave, based on the processes tax administrators undertake in managing them.<sup>13</sup> The rationale for using the procedural justice framework is because literature has shown that decisions and processes used by authorities on its citizens affect their behaviour.<sup>14</sup>

This paper explicitly considers two issues. First, it explores how small business taxpayers are relationally treated during audits and queries by tax officers in New Zealand. Second, it discusses the perceptions of small business owners towards the tax authority in New Zealand. This question is of interest because research into compliance has shown that sanctions that are perceived to be unfair or unreasonable can often lead to active resistance towards the tax authority.<sup>15</sup>

As audit-query experiences are particular to each taxpayer, the qualitative-interpretive methodology, with the use of semi-structured face-to-face interviews, was considered the best approach to gather this type of information.<sup>16</sup> Qualitative research relies on

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<sup>7</sup> Jeffrey Dubin and Louis Wilde, 'An Empirical Analysis of Federal Income Tax Auditing and Compliance' [1988] (March) *National Tax Journal* 61; Joel Slemrod, Marsha Blumenthal and Charles Christian, 'Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota' (2001) 79(3) *Journal of Public Economics* 455; Brian Erard, 'The Influence of Tax Audits on Reporting Behaviour' in Joel Slemrod (ed), *Why People Pay Taxes: Tax Compliance and Enforcement* (University of Michigan, 1992) 95.

<sup>8</sup> Michael Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis' [1972] (November) *Journal of Public Economics* 323.

<sup>9</sup> Andrew Cuccia, 'The Economics of Tax Compliance: What Do We Know and Where Do We Go?' (1994) 13 *Journal of Accounting Literature* 81.

<sup>10</sup> Allingham and Sandmo, above n 8.

<sup>11</sup> Marsha Blumenthal, Charles Christian and Joel Slemrod, 'Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota' (2001) 54 *National Tax Journal* 125; Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University, 1992).

<sup>12</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, 565.

<sup>13</sup> Kristina Murphy, 'Procedural Fairness and Tax Compliance' (2003) 38(3) *Australian Journal of Social Issues* 379; Michael Blissenden, 'Procedural Fairness and Non-Assessing Decisions of the Federal Commissioner of Taxation' (2002) 5(3) *Journal of Australian Taxation* 466.

<sup>14</sup> Jason Sunshine and Tom Tyler, 'The Role of Procedural Justice and Legitimacy in Shaping Public Support for Policing' (2003) 37(3) *Law and Society Review* 513; Tom Tyler, *Why People Obey the Law* (Princeton University, 2006); Blissenden, above n 13.

<sup>15</sup> Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University, 1992); Murphy, 'Regulating More Effectively' above n 12.

<sup>16</sup> For more information on the qualitative research methodology see John Cullis and Alan Lewis, 'Why People Pay Taxes: From a Conventional Economic Model to a Model of Social Convention' (1997) 18 *Journal of Economic Psychology* 305; Norman Denzin and Yvonna Lincoln, 'Introduction: The Discipline and Practice of Qualitative Research' in Norman Denzin and Yvonna Lincoln (eds), *The Sage Handbook of*

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triangulation to achieve research rigour and credibility,<sup>17</sup> and therefore the accounts of the business taxpayers are corroborated by inclusion of other sources, namely tax practitioners and business experts. These two groups were chosen because they interact with small business taxpayers on a commercial and personal basis.

The structure of this paper is as follows. Part II discusses the rationale for researching small businesses. Part III examines the literature pertaining to tax compliance of small businesses and the theoretical framework. Part IV discusses the research methodology. Part V sets out the findings and analysis. Part VI concludes the paper with suggestions for future research.

## II RATIONALE FOR SMALL BUSINESSES RESEARCH

Tax revenues are collected by governments to fulfil three main kinds of objective: fiscal, economic, and social.<sup>18</sup> The approaches adopted by tax authorities to regulate and collect taxes from small businesses are important in influencing tax perceptions<sup>19</sup> as small businesses contribute significantly to the economy in terms of valued added outputs and employment.<sup>20</sup> Furthermore, small businesses are important tax collectors on behalf of governments in terms of consumption, employment, and income taxes.<sup>21</sup> They have custody over these taxes for a time period and are required to account for and surrender them to the tax authorities on due dates.<sup>22</sup> Due to their tax collection efforts,<sup>23</sup> small business taxpayers have more interactions with tax authorities than wage and salary earners do.<sup>24</sup> They have comparatively greater sanctions from tax authorities<sup>25</sup> because of their relatively low tax compliance statistics.<sup>26</sup> Some participate in the cash economy<sup>27</sup>

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*Qualitative Research* (Sage, 3<sup>rd</sup> ed, 2005) 1; David Silverman and Amir Marvasti, *Doing Qualitative Research: A Comprehensive Guide* (Sage, 2008).

<sup>17</sup>Joseph Maxwell, 'Understanding and Validity in Qualitative Research' in Michael Huberman and Matthew Miles (eds), *Qualitative Researcher's Companion: Classic and Contemporary Reading*, (Sage, 2002) 37; Jill McKinnon, 'Reliability and Validity in Field Research: Some Strategies and Tactics' (1988) 1(1) *Accounting, Auditing and Accountability Journal* 34.

<sup>18</sup> Clinton Alley et al, *New Zealand Taxation* (Thomson/Brokers, 1<sup>st</sup> ed, 2004); Francis Chittenden, Saleema Kauser and Panikkos Poutziouris, 'Tax Regulation and Small Business in the USA, UK, Australia and New Zealand' (2003) 21(1) *International Small Business Journal* 93.

<sup>19</sup> Kristina Murphy, 'An Examination of Taxpayers' Attitudes Towards the Australian Tax System: Findings from a Survey of Tax Scheme' (2003) 18(2) *Australian Tax Forum* 209.

<sup>20</sup> Ministry of Economic Development, above n 4; OECD, *SME Statistics: Towards a More Systematic Statistical Measurement of SME Behaviour* (2004).

<sup>21</sup> David Joulfaian, 'Bribes and Business Tax Evasion' (2009) 6(2) *The European Journal of Comparative Economics* 227; David Joulfaian and Mark Rider, 'Differential Taxation and Tax Evasion by Small Business' (1998) 51(4) *National Tax Journal* 675.

<sup>22</sup> Chris Evans, Shirley Carlon and Darren Massey, 'Record Keeping Practices and Tax Compliance of SMEs' (2005) 3(2) *eJournal of Tax Research* 288.

<sup>23</sup> Carol Adams and Paul Webley, 'Small Business Owner's Attitudes on VAT compliance in the UK' (2001) 22(2) *Journal of Economic Psychology* 195.

<sup>24</sup> Eric Kirchler, *The Economic Psychology of Tax Behaviour* (Cambridge, 2007).

<sup>25</sup> Eliza Ahmed and Valerie Braithwaite, 'Understanding Small Business Taxpayers: Issues of Deterrence, Tax Morale, Fairness and Work Practice' (2005) 23(5) *International Small Business Journal* 539.

<sup>26</sup> Paul Caragata, *The Economic and Compliance Consequences of Taxation: A Report on the Health of the Tax System in New Zealand* (1998); Ahmed and Braithwaite, above n 25; Ian Wallschutzky, 'Possible Causes of Tax Evasion' (1984) 5(4) *Journal of Economic Psychology* 371.

with 'unregistered income with no third party reporting.'<sup>28</sup> They are therefore considered the 'hard to tax group from the informal sector.'<sup>29</sup> Given that, tax authorities can benefit from knowledge of how small businesses comply with tax requirements in order to strategise regulatory and monitoring measures to effectively manage small businesses.

### III LITERATURE REVIEW AND THEORETICAL FRAMEWORK

#### *A Tax Compliance of Small Businesses*

Research has confirmed several tax compliance factors. These are: economic self interest;<sup>30</sup> social and psychological factors,<sup>31</sup> and tax morale, which refers to complying out of obligation as citizens of a country.<sup>32</sup> As mixed results were obtained from investigation of the above factors, several authors have suggested that tax compliance is multi-faceted and is dependent on a combination of factors.<sup>33</sup> Given this, considerations such as procedural justice (the way in which taxpayers are treated by the tax authority) may help explain why there might be lower tax compliance statistics for small businesses relative to other taxpayer groups such as the wage and salary earners.<sup>34</sup>

Burton observes that Australian small businesses had been 'sorely dealt with at the hands of oppressive government regulation'<sup>35</sup> and politicians and bureaucrats are finding ways to compensate small businesses for this injustice. Between 2005 to 2011, 10 of the total 72 publications in the Journal of the Australasian Tax Teachers Association (JATTA) were focussed on small businesses. This testifies to the increasing interest and importance of this taxpayer group to academics and practitioners. Some of these papers argued that small businesses did not get a fair deal from the tax system due

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<sup>27</sup> Julie Ashby and Paul Webley, 'But Everyone Else is Doing It: A Closer Look at the Occupational Taxpaying Culture of One Business Sector' (2008) 18 *Journal of Community & Applied Social Psychology* 194; Susan Morse, Stewart Karlinsky and Joseph Bankman, 'Cash Businesses and Tax Evasion' (2009) 20(1) *Stanford Law and Policy Review* 37.

<sup>28</sup> Klarita Gerxhani and Arthur Schram, 'Tax Evasion and Income Source: A Comparative Experimental Study' (2006) 27 *Journal of Economic Psychology* 402, 403.

<sup>29</sup> Robert McGee, Simon Ho and Annie Li, 'A Comparative Study on Perceived Ethics of Tax Evasion: Hong Kong vs the United States' (2008) 77 *Journal of Business Ethics* 147, 147.

<sup>30</sup> For more information on the economic self interest theory see Allingham and Sandmo, above n 8; James Alm and Michael McKee, 'Extending the Lessons of Laboratory Experiments on Tax Compliance to Managerial and Decision Economics' (1998) 19 *Journal of Managerial and Decision Economics* 259.

<sup>31</sup> Cullis and Lewis, above n 16; James Alm, Isabel Sanchez and Ana De Juan, 'Economic and Noneconomic Factors in Tax Compliance' (1995) 48 *KYKLOS* 3.

<sup>32</sup> Bruno Frey and Benno Torgler, 'Tax Morale and Conditional Cooperation' (2007) 35 *Journal of Comparative Economics* 136; Benno Torgler, 'Tax Morale and Direct Democracy' (2005) 21 *European Journal of Political Economy* 525.

<sup>33</sup> James Andreoni, Brian Erard, and Jonathan Feinstein, 'Tax Compliance' (1998) XXXVI *Journal of Economic Literature* 818; Cullis and Lewis, above n 36.

<sup>34</sup> Ahmed and Braithwaite, above n 25; Peter Noble, 'Qualitative Research Results: The New Zealand Cash Economy – A Study of Tax Evasion Amongst Small and Medium Businesses' (Paper presented at the CTIS 1st International Conference, Canberra, 4 December 2000).

<sup>35</sup> Mark Burton, 'Small Business Tax Advantages — Towards Holism with a Suggested Definition, Typology and Critical Review' (2006) 2(2) *Journal of the Australasian Tax Teachers Association* 78, 105.

to high start up costs<sup>36</sup> with regressive tax compliance costs,<sup>37</sup> despite various government initiatives to simplify tax requirements<sup>38</sup> and to compensate them for these injustices.<sup>39</sup> Freeman, however, cautions of the difficulty in implementing tax policies for small businesses, due to the differences from other taxpayer groups in terms of cash job opportunities and few or no withholding taxes paid.<sup>40</sup>

Discussions on small business tend to gravitate towards identifying them as a distinct taxpayer group that ought to be nurtured by tax regulators and policy makers. If that is the case, then the way in which this taxpayer group is being treated procedurally may play an important role in determining their tax compliance level and their perceptions of the tax authority and tax system. This paper aims to explore the impact of procedural justice in audits undertaken by the IRD on small business taxpayers in Auckland, New Zealand between 2006 and 2010.

### ***B Procedural Justice Framework***

Research has shown that perceptions of procedural justice affect people's attitudes and behaviours.<sup>41</sup> Individuals who feel an authority has treated them with dignity, respect, and fairness are more likely to make positive evaluations about that authority and will be more likely to comply with that authority's rules and regulations.<sup>42</sup> Procedural justice is concerned with the 'perceived fairness of the procedures involved in decision making and the perceived treatment one receives from a decision maker.'<sup>43</sup> Specifically, procedural justice is associated with the neutrality of procedure, the trustworthiness of the authority, and with the authority's representatives being polite and respectful towards individuals when interacting with them.<sup>44</sup> Tax procedures that are neutral and are consistently applied to all will favourably impact on the taxpayers' perceptions of fairness.<sup>45</sup>

Relational models of procedural justice postulate that people's motivation for compliance extends beyond their concern for favourable outcomes, but recognise the

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<sup>36</sup> Nthathi Rametse and Jeff Pope, 'Business Start-Up Compliance Costs: Policy Perspectives' (2005) 1(3) *Journal of the Australasian Tax Teachers Association* 84.

<sup>37</sup> Paul Lignier, 'The Costs and Benefits of Complying with the Tax System and their Impact on the Financial Management of the Small Firm' (2006) 2(1) *Journal of the Australasian Tax Teachers Association* 121.

<sup>38</sup> Michael Dirkis and Brett Bondfield, 'Much Ado about Nothing: Ralph's Consideration of Small Business' (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 110.

<sup>39</sup> Burton, above n 35.

<sup>40</sup> Judith Freeman, 'Why Taxing the Micro-Business is Not Simple — A Cautionary Tale from the "Old World"' (2006) 2(1) *Journal of the Australasian Tax Teachers Association* 58.

<sup>41</sup> Murphy, 'Regulating More Effectively', above n 12; Sunshine and Tyler, above n 14.

<sup>42</sup> Tom Tyler, 'Why People Obey the Law' above n 14; Tom Tyler and Yuen Huo, *Trust in the Law: Encouraging Public Cooperation with the Police and Courts* (Russell Sage Foundation, 2002).

<sup>43</sup> Kristina Murphy, 'Procedural Justice and Affect Intensity: Understanding Reactions to Regulatory Authorities' (2009) 22 *Social Justice Research* 1, 2.

<sup>44</sup> Tom Tyler and Edgar Lind, 'A Relational Model of Authority in Groups' in M Zanna (ed), *Advances in Experimental Social Psychology*, (Academic Press, 1992) 115.

<sup>45</sup> Kristina Murphy, Tom Tyler and Amy Curtis, 'Nurturing Regulatory Compliance: Is Procedural Justice Effective When People Question the Legitimacy of the Law' (2009) 3 *Regulation & Governance* 1.

'importance of interpersonal treatment in determining whether people will obey the law.'<sup>46</sup> According to Tyler and Lind, people will judge procedures as fair when authorities communicate feelings of self-worth with fair and neutral procedures and are respectful of citizen's rights.<sup>47</sup> It is argued that people who feel treated fairly by the authorities will regard the authority's status as legitimate and therefore will be 'more likely to follow and accept their decision regardless of the favourability of the decision outcome.'<sup>48</sup>

Studies of procedural justice indicate that people typically consider two aspects of how decisions are being made: the processes of decision making and the manner in which they have been treated while decisions are being made. The process of decision making includes whether people are given an opportunity to present their views, whether procedures are neutral, transparent, and fact-based, and whether rules and policies are consistently applied across people and over time.<sup>49</sup> The manner in which people have been treated includes whether the processes are dignified, and whether the authorities are honest, polite, and respectful of the people's rights.<sup>50</sup> In all, research has shown that if people believe that an authority has tried to be fair with them, that they have been treated with respect, and that they have been dealt with in an impartial way, then these factors enhance feelings of fairness.<sup>51</sup>

Given the above, the way in which taxpayers are treated by the tax authority is important in influencing the fairness perception.<sup>52</sup> Wenzel found Australian taxpayers to be more compliant when they feel that the ATO has treated them in a fair and respectful manner.<sup>53</sup> He also found that trust in the ATO increased when tax officers treated taxpayers as equals, in a respectful and responsible way.<sup>54</sup> In another study, Wenzel also found that taxpayers reacted more positively to letters from the ATO when they showed respect to the taxpayers, compared to letters that were disrespectful, harsh, and overly authoritarian.<sup>55</sup> Similarly, Australian tax scheme investors were found to be more compliant when tax authorities treated them in a fair and unbiased manner.<sup>56</sup> In New

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<sup>46</sup> Tom Tyler, 'The Psychology of Procedural Justice: A Test of the Group-Value Model' (1989) 57 *Journal of Personality and Social Psychology* 830, 830.

<sup>47</sup> Tyler and Lind, above n 44.

<sup>48</sup> Michael Wenzel, 'A Letter from the Tax Office: Compliance Effects of Informational and Interpersonal Justice' (2006) 19(3) *Social Justice Research* 345, 346.

<sup>49</sup> Tom Tyler, John Dienhart and Terry Thomas, 'The Ethical Commitment to Compliance: Building Value-Based Cultures' (2008) 50(2) *California Management Review* 33.

<sup>50</sup> Ibid.

<sup>51</sup> Tyler, 'Why People Obey the Law', above n 14; Murphy, 'An Examination of Taxpayers' Attitudes Towards the Australian Tax System', above n 19.

<sup>52</sup> Murphy, 'Procedural Fairness and Tax Compliance', above n 13; Tom Tyler, 'Trust and Democratic Governance' in Valerie Braithwaite and Margaret Levi (eds), *Trust and Governance* (Russell Sage Foundation, 1998) vol 1, 269.

<sup>53</sup> Michael Wenzel, 'The Impact of Outcome Orientation and Justice Concerns on Tax Compliance: The Role of Taxpayers' Identity' (2002) 87 *Journal of Applied Psychology* 629.

<sup>54</sup> Michael Wenzel, 'Tax Compliance and the Psychology of Justice: Mapping the Field' in Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (Ashgate, 2003) 41.

<sup>55</sup> Wenzel, 'A Letter from the Tax Office', above n 48.

<sup>56</sup> Murphy, 'An Examination of Taxpayers' Attitudes Towards the Australian Tax System', above n 19.

Zealand, perceptions of unfair treatment from the tax authorities were found to adversely affect taxpayers' compliance levels.<sup>57</sup>

#### IV RESEARCH METHODOLOGY AND PARTICIPANTS' PROFILE

Due to the individual nature of the participants' relational experiences with the tax authority, qualitative research with the use of semi structured face-to-face interviews was considered the best approach to collect the data.<sup>58</sup> The interviews took place between 2006 and 2010 and they were tape recorded with the consent of the participants. The prime reason for in-depth interviews is to understand the substance of the participant's experiences, as described from their perspective but interpreted by the researcher.<sup>59</sup> Moreover, the participant's perception of the tax authority is partly dependent on their relational experiences with the tax authority, and is best captured by interviews. Research has shown that qualitative studies can contribute to social theories by detailing the context, the social processes and the explanation for individual behaviours and beliefs.<sup>60</sup> The strength of qualitative research is two fold. First, it has the ability to explore social issues in depth and from the perspectives of actual participants.<sup>61</sup> Second, the concepts, meanings and explanations are developed inductively from the data.<sup>62</sup>

##### *A Participants' Profile and the Sampling process*

A total of 36 small business taxpayers who participated in the interview were selected based on purposeful-theoretical and snowballing sampling processes.<sup>63</sup> These selection methods are commonly found in qualitative research, as the aim is to gain an in-depth understanding of a phenomenon.<sup>64</sup> The sampled business taxpayers had been 'purposefully selected'<sup>65</sup> because of their personal encounters with the tax authority and to illuminate their relational experiences with representatives from the tax authority. Participants were 'information rich'<sup>66</sup> as they provide in-depth accounts of diverse

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<sup>57</sup> 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.

<sup>58</sup> Tim Rapley, 'Interviews' in Clive Seale et al, (eds), *Qualitative Research Practice* (Sage, 2007); Irving Seidman, *Interviewing as Qualitative Research* (Teachers College Press,1991); Carol Warren and Tracy Karner, *Discovering Qualitative Methods: Field Research, Interviews and Analysis* (Roxbury Publishing, 2005).

<sup>59</sup> Victor Minichiello, Rosalie Aroni and Terrence Hays, *In Depth Interviewing* (Pearson Education, 3<sup>rd</sup> ed, 2008) 11; Margaret McKerchar, *Design and Conduct of Research in Tax, Law and Accounting* (Thomson Reuters, 2010) 154.

<sup>60</sup> Sotirio Sarantakos, *Social Research* (Palgrave Macmillan, 3<sup>rd</sup> ed, 2005).

<sup>61</sup> Norman Denzin and Yvonna Lincoln. 'Introduction: Entering the Field of Qualitative Research' in Norman Denzin and Yvonna Lincoln (eds), *Handbook of Qualitative Research* (Sage Publications, 1994) 1, 12.

<sup>62</sup> McKerchar, above n 59.

<sup>63</sup> Pranee Liamputtong, *Qualitative Research Methods* (Oxford University Press, 3<sup>rd</sup> ed, 2009).

<sup>64</sup> W. Lawrence Neuman, *Social Research Methods: Qualitative and Quantitative Approaches* (Pearson Education, 7<sup>th</sup> ed, 2011).

<sup>65</sup> Michael Patton, *Qualitative Research & Evaluation Methods* (Sage Publications, 3<sup>rd</sup> ed, 2002) 242.

<sup>66</sup> Ibid 230.



experiences with the tax authority with regard to collecting and accounting for the various taxes in New Zealand.

### 1 *Purposeful-Theoretical Sampling*

Theoretical sampling is not representative sampling, of which a particular sample is drawn from a population to which one can generalise to the population.<sup>67</sup> Instead, theoretical sampling intends to provide contrasting settings through which theoretical comparisons can be made.<sup>68</sup> In this study, the contrasting settings are based on ethnic, industry, and age of business differences.

As business taxpayers' interactions with the tax authority are personalised encounters, these interactions are therefore useful for theoretical or analytical generalisations.<sup>69</sup> Theoretical generalisations make theory-related concepts and propositions,<sup>70</sup> which can be applied beyond the sample studied.<sup>71</sup> This is because conclusions are drawn from constructs developed from the participants studied, which are then transferable to other cases that face similar contexts.<sup>72</sup> The degree to which the findings from a study support existing theories can be assessed by 'comparing how well different cases *fit* within an established theory and how far it is able to explain behaviour in individual cases.'<sup>73</sup> This is unlike empirical generalisations, which are commonly found in quantitative studies (which uses representative sampling) to make statistical inferences about the population.<sup>74</sup>

### 2 *Snowballing Sampling*

From the initial sample of taxpayers interviewed, further participants were sought using the snowballing sampling process. The initial participants were asked to recommend other people who met the research criteria and were willing to participate in the research.<sup>75</sup> This process is continued with the new participants until saturation;<sup>76</sup> that is, until no more substantial information can be acquired through additional participants. Saturation took place when 32 business taxpayers were interviewed. However, to confirm that there were no new findings, a further four participants were interviewed, making a total of 36 taxpayer participants.

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<sup>67</sup> Ian Dey, 'Grounded Theory' in Clive Seale et al, (eds), *Qualitative Research Practice* (Sage Publications, Concise Paperback ed, 2008) 80, 90.

<sup>68</sup> Ibid.

<sup>69</sup> Sarantakos, above n 60.

<sup>70</sup> Ibid 98.

<sup>71</sup> Jane Lewis & Jane Ritchie, 'Generalising from Qualitative Research', in Jane Ritchie and Jane Lewis (eds), *Qualitative Research Practice: A Guide for Social Science Students and Researchers* (Sage, 2003) 263, 264.

<sup>72</sup> Sarantakos, above n 60.

<sup>73</sup> Lewis and Ritchie, above n 71, 267.

<sup>74</sup> Clive Seale, *The Quality of Qualitative Research* (Oxford, 1999); Sarantakos above n 60, 98.

<sup>75</sup> McKerchar, above n 59, 150.

<sup>76</sup> Sarantakos, above n 60, 165.

### 3 Profiles of Participants

All 36 business taxpayers were drawn from the Auckland region,<sup>77</sup> and the industries they operated in were representative of 14 of the total 19 sectors listed on the Australian and New Zealand Standard Industrial Classification (ANZSIC).<sup>78</sup> The industrial sectors of these small businesses cover 74 per cent of the industry groups listed on the ANZSIC. In addition to convenience sampling, Auckland has been chosen as it has the highest number of small businesses in New Zealand,<sup>79</sup> and it is the most ethnically diverse region in the country.<sup>80</sup>

There was equal representation from the four largest ethnic groups in New Zealand, namely: European, Asian, Maori, and Pacific Peoples, which reflects the country's population structure. Eighty eight per cent were micro businesses (with up to five employees), with the remainder small businesses. Forty four per cent of those interviewed were males, 47 per cent were female, and nine per cent were husband and wife teams. Thirty one per cent of the businesses were five years old and under, 36 per cent were between six and 10 years old, 28 per cent were more than 10 years old, and five per cent did not disclose the age of their business.

Questions asked of the business taxpayers concerned their demographic profile, their perceptions of tax compliance, and their relational experiences with the IRD. These questions can be found in Appendix 1.

### 4 Triangulation

In order to achieve a higher degree of validity, credibility, and research utility, the triangulation process<sup>81</sup> has been adopted for this study. Triangulation involves the use of different methods or sources to 'check the integrity of, or extend, inferences drawn from the data.'<sup>82</sup> In this study, sample triangulation<sup>83</sup> was used. This involves choosing

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<sup>77</sup> Auckland is the largest city in New Zealand, with the highest concentration of the four largest ethnic groups namely: European, Asian, Maori, and Pacific Peoples. For more information see Ministry of Economic Development, above n 4.

<sup>78</sup> There are 19 industrial sectors classified by the 2006 ANZSIC namely: agriculture, forestry and fishing; mining; manufacturing; electricity, gas, water and waste services; construction, wholesale trade; retail trade; accommodation and food services; transport, postal and warehousing; information media and telecommunications; financial and insurance services; rental, hiring and real estate services; professional, scientific and technical services; administrative and support services; public administration and safety; education and training; health care and social assistance; arts and recreation services; and other services: see Ministry of Economic Development, above n 4, 19.

<sup>79</sup> Ministry of Economic Development, above n 4, 21.

<sup>80</sup> Statistics New Zealand, *2006 census data — QuickStats-about-culture-and-identity-tables.xls* (2006) <<http://www.stats.govt.nz.ezproxy.aut.ac.nz/Census/2006CensusHomePage/QuickStats/quickstats-about-culture-and-identity-tables>>.

<sup>81</sup> Sarantakos, above n 60, 146.

<sup>82</sup> Jane Ritchie, 'The Application of Qualitative Methods to Social Research' in Jane Ritchie & Jane Lewis (eds), *Qualitative Research and Practice* (Sage Publications, 2003) 24, 43.

<sup>83</sup> Sarantakos, above n 60, 98.

participants from a variety of backgrounds and from different sources to ensure accuracy and credibility of findings.<sup>84</sup>

As taxpayers' perceptions of the tax authority may be influenced by the treatment they experienced from the tax authority, this study sought the views of eight tax agents and 15 business experts as sources of information to verify the taxpayers' accounts. The eight tax agents consisted of equal representation of males and females, and half were sole practitioners, with the other half from small and medium sized accounting firms. Questions asked of the tax agents referred to their demographic details, their interactions with small businesses and with the IRD, as well as their perceptions of tax compliance for small businesses. These questions can be found in Appendix 2.

The 15 business experts who corroborated the accounts of the taxpayers in this study were business mentors/coaches, regulators, policy makers, and advisors to small business owners. They were representatives from the IRD, Chamber of Commerce, Ministry for Maori Development, Pacific Business Trust, Small Business Advisory Group, Maori Womens Development Incorporated, New Zealand Government (a Minister of Parliament), New Zealand Trade and Enterprise, and Business New Zealand. Business experts were included in this sample as they interact with small business owners by providing financial, business, and tax advice. Questions asked of the business experts included identification of their role and involvement with small businesses, their perceptions of tax compliance for small businesses, and how small businesses manage their compliance requirements. These questions can be found in Appendix 3.

## **V FINDINGS AND ANALYSIS**

This section incorporates both the findings and analysis by using the procedural justice framework. This section is divided into several parts. First, it examines the participants' relational experiences with the IRD. These experiences are subdivided into positive and negative experiences. Further indications of negative experiences leading to taxpayers' perceptions towards the tax authority are also discussed. Finally, the adverse consequences of the tax authorities' lack of procedural justice are discussed.

### ***A Participants' Relational Experiences with the IRD***

The sample selected for this study experienced a mixture of positive and negative relational treatment from the IRD. An example of positive treatment was helpful and sympathetic IRD staff, whereas negative treatment included inefficiency, inflexibility, intimidation, insensitivity, inconsistency, and incompetency of IRD representatives. These are discussed at depth in the ensuing subsections.

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<sup>84</sup> Patton, above n 65, 93.

### 1 *Positive Experiences with the IRD*

Only three of the 36 small business (SB) taxpayers experienced positive treatment from the IRD. These taxpayers found IRD staff to be helpful and sympathetic and they experienced better than expected treatment than their peers:

I had a woman from the IRD who helped me through things and to see that there was a solution to my tax debt. I had to work really hard to get out of that situation. The IRD is not as bad as what my peers told me. (SB22 — Maori female.)

The IRD queried us on how we calculate our GST. We got stung with a bill because we under-calculate our GST simply because we did not have our system in place ... We find with the IRD if we disclose everything they are good to us ... They made all our penalties nil and they accepted all our terms of how we were going to pay the debt off. (SB29 — Pacific male.)

To a certain extent I do find the IRD to be helpful at times. I still have to ask them to speak plainly as possible so that I can grasp what they are talking about or to talk slower. (SB21 — Pacific female.)

Two tax agents (TA) also found IRD staff to be professional in their conduct, and their audit encounters were similar to those described in the following quote:

I handle the audits for my clients and the audit experience was better than I thought. What the IRD is after is to find some answers to their query ... It wasn't a harrowing experience and the IRD was quite nice and were very professional about it. (TA5 — sole practitioner.)

However the above positive experiences were relatively few compared to negative treatment most taxpayers had encountered.

### 2 *Negative Experiences with the IRD*

Common complaints from taxpayers and tax agents regarding the tax authority relate to unhelpful and judgemental IRD staff. In general, the business taxpayers in this study felt detached from the tax system because the IRD did not understand their needs. Often, tax jargon and intimidating tactics used by IRD staff discouraged business taxpayers from contacting the IRD directly. Instead, the majority relied on their accountants or peers as sources of tax information.<sup>85</sup> The specific negative treatment received from the IRD is discussed in the ensuing subsections.

### 3 *Inefficient, Impersonal, Inflexible and Inconsistent IRD staff*

Small business taxpayers felt that IRD staff met their expectations of government bureaucratic departments in that they were inefficient, impersonal, intimidating, inflexible, and inconsistent. Most business taxpayers felt that IRD staff viewed them as

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<sup>85</sup> This is consistent with the findings that government agencies, including the IRD, are least preferred and least used compared to accountants, bankers, and peers in Lewis Kate et al, *Family, Friends and Government Agencies: A Report on SMEs and the Support Infrastructure* (New Zealand Centre for SME Research, 2005) 1.

citizens with obligations to pay their taxes, and therefore they were not treated politely, consistently, fairly, nor in a respectful manner. For some, the audit processes were made difficult by inflexible IRD staff, which is similar to the experiences reported by small businesses in the United Kingdom:<sup>86</sup>

The IRD officer that dealt with us had no sense of humour or any personality at all. He was a bit inflexible as he wanted to check for every single invoice even though the invoice was stated in the supplier's monthly statement. (SB15 — European husband and wife team.)

My family was audited. It was an ugly experience for them. They had to pay some penalty and that wasn't a nice experience. It was a tense experience in the farm because they (IRD) were right and everyone else was wrong. (SB2 — European female.)

I find the IRD is acting like a police rather than a collection agency. She behaved more like a judge. (SB1 — Asian female.)

Occasionally I will ring the IRD but this is about ten years ago. I would now speak to our accountant as I have been 'burnt' by the IRD ages ago because they gave us the wrong information. The IRD does not care whether you have got misinformation or not and you are responsible for the tax returns filed. (SB9 — European female.)

The above taxpayers' experiences showed that the IRD had not adopted procedural justice in their conduct. Inefficient, inconsistent and incompetent IRD administrators were noted by business experts (BE) and tax agents as contributing factors for the negative tax perceptions by the small business community:

The small businesses view of the IRD is not very good. They want little to no contact at all with the IRD if they can help it. This is because to get to the right person in the IRD if you have a query is really difficult. You can be asking the same question and two different IRD representatives can sometimes give you two different answers. (TA1 — sole practitioner.)

Most small businesses find it confusing when they ask one IRD officer and they give them an answer and then when they ask another officer, they are given a completely different answer. (BE7 — advisor to the government)

The lack of fair procedures experienced by small businesses has caused an overall negative perception of the IRD in New Zealand:

I know from my discussion with small businesses that they tend to talk negatively about the IRD. (BE5 — Maori business mentor.)

They have always considered the IRD to be the bad boys, the bogeyman you know — truly. (BE10 — Pacific business mentor.)

#### 4 *Judgemental IRD Staff*

Experiencing judgemental IRD staff was one of the common experiences for taxpayers and tax agents in this study. This form of biased treatment reinforces the perceptions of

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<sup>86</sup> Adam and Webley, above n 23.

small businesses that the IRD has unfair practices. Due to fear of dealing with the IRD, many taxpayers delegated their tax audits-queries to their tax agents, resulting in higher compliance costs. In some instances, tax agents also found vindictive IRD staff who were determined to find faults with their clients:

The auditors came expecting to find something. But we know what we were doing and they were happy with our records and asked us to keep the records for seven years! (SB14 — Asian male.)

I invested in a mining company and the company has been audited every month because they have GST refunds every month. It is all legitimate because it has something to do with mining. The company knew that it was going to happen and the accountant has all the checks and balances and is ready for them every month. (SB5 — European male.)

It varies, they can be incredibly good auditors and also some malicious, vindictive auditors who are on a mission and we have laid complaints. There is no doubt that there are some very good audit staff and they go in with the perception that errors found are genuinely made by the clients but yet there are some who have the perception that the errors made by the clients are deliberate. (TA8 — partner of a medium sized CA firm.)

The above accounts showed that some taxpayers were being pre-judged by IRD staff even before the audit-query process. This is procedurally unfair as taxpayers had to undertake extensive measures to prove their innocence. The lack of neutral and fair treatment received by the small business owners from the IRD had led to some tax resistance:

During the audit, we had to pay the accountant to deal with the IRD. If we have the audit, you can be nervous and there is certain anxiety that can make your presentation to the IRD incorrectly. (SB12 — European male.)

I would not like the IRD to come and visit me and I want the tax man to stay away. (SB5 — European male.)

## 5 *Unsympathetic and Insensitive IRD staff*

Small business taxpayers had also encountered unsympathetic IRD staff who were not sensitive to their needs. These IRD representatives were quick to penalise small businesses and were unwilling to give concessions regardless of their circumstances:

My husband has been queried before by the IRD for not filing a tax return before we left for Canada. He had a head injury and was returning to work for a couple of hours and did not keep an invoice book. The IRD would not give us a diversion and assessed us on a large sum of money which took us 7 months to pay. They were not at all sympathetic and they interrogated us. They do not need to be so heavy handed. (SB4 — Maori female.)

As a consequence of the IRD's heavy handed tactics, it created a culture of fear amongst small business towards the IRD:

Fear of the IRD, they can be more user-friendly or more encouraging. (SB34 — Pacific male.)

Fear the IRD. Don't get on the bad books with the IRD as the IRD is unforgiving and nasty. I think the main thing is not to get on the wrong side with the IRD as the penalties will come on you quite heavy when you are filing late. They are quite ruthlessly and there is no grace period. Just dealing with them is quite difficult. They are not helpful and that you are dealing with the bureaucracy. (SB 25 — Maori male.)

Part of this fear may be attributable to power imbalance in the taxpayer-IRD relationship and possibly poor knowledge of taxpayers' rights and obligations. These factors could be verified with further research. However, in this study, fear towards the IRD resulted in 30 of the 36 small business owners saying they would not consult the IRD even if they had a tax query. This is disappointing given that significant resources had been expended to generate a more 'customer-focussed' service to taxpayers since the emergence of the Taxpayer Charter 2001.<sup>87</sup> These findings show the absence of procedural justice to be one of the primary reasons for the poor working relationship between small businesses and the IRD.

### 6 *Untrained and Unqualified IRD staff*

Small business taxpayers and their tax agents had encountered unqualified IRD staff, thereby increasing their audit costs. Incompetent IRD auditors were a consequence of poor induction and training by the IRD, which confirmed findings from the New Zealand Auditor-General regarding the poor induction practices of IRD for tax auditors.<sup>88</sup>

My feeling is that the IRD officers are not highly trained. (TA4 — sole practitioner.)

Many of the auditors are not very qualified. (SB3 — Asian female.)

I had to go through the 7 year audit with this tax guy who was a farmer and he was very rigorous and they (2 of them) spent 1 week with us. After 1 week and another month of deliberation, they then narrow down to one area which was the transfer pricing — a new area at that time. (TA2 — sole practitioner.)

To address the issue of incompetent IRD staff, the tax agents in this study queried interpretation of statutes by the IRD representatives, and were proven correct:

I have sometimes challenged their interpretation of the statutes and they have gone away and come back to agree with our interpretation. You do not expect them to know everything. (TA8 — partner of a medium sized CA firm.)

We had a Fringe Benefit Tax (FBT) audit and I had to tell the IRD auditors about some of the Goods and Services Tax (GST) treatment and ask them to check it out. They thought that I was wrong. (TA1 — sole practitioner.)

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<sup>87</sup> For more information on the importance of the Taxpayer Charter, refer to Sue Yong and Alvin Cheng, 'The IRD Taxpayer Charter and the Small Business Community' (2011) 17(3) *New Zealand Journal of Taxation Law and Policy* 1.

<sup>88</sup> Controller and Auditor-General, *Inland Revenue Department: Performance of Taxpayer Audit — Report of the Controller and Auditor-General* (2003) 1.

The result of untrained and unqualified IRD staff had led to anxiety and tax compliance costs for small businesses, as their accountants had to prove their innocence. This is procedurally unfair, which perpetuates small businesses' negative perceptions towards the IRD and their unwillingness to interact with them:

No, I don't think the small businesses have a good view about the IRD. I think there is a bit of feeling that once they are in the spotlight or on the IRD records, they feel that they have the burden as far as the IRD is concerned. I think they don't feel comfortable dealing with the IRD and they hire the accountants as the buffer when dealing with the IRD. (TA3 — sole practitioner.)

### 7 *Ineffective Audits*

In addition to having untrained and unqualified IRD staff, two tax agents had found the audit processes to be ineffective in detecting errors made by business taxpayers. IRD auditors were fixated with only one aspect of the audit and ignored the other interrelated aspects, hence overlooking other tax errors. These findings are consistent with what was found by the New Zealand Auditor-General regarding some poor audit practices of the IRD:<sup>89</sup>

It amazed me how few the audits were and the audits were always random. They come to do small audits and they come and check the car expenses and they appeared to be relatively new employees of the IRD. The other major weakness of the IRD audit is that they never look at the whole picture of the GST, FBT, and Income Tax. If there is a problem there, then there is a flow on effect from there. (TA4 — sole practitioner.)

From the above accounts, the tax agents suggest that more effective audits require a holistic approach to minimise any flow-on effects. By doing this, they may prevent future problems from recurring, as well as conducting effective tax audits. Ineffective audits are procedurally unfair to small businesses, as they could be costly to them in the long run when potentially interrelated accounting errors re-emerge in the future. The overall audit-query experiences faced by taxpayers and tax agents in this study are best summarised and depicted in Diagram 1 in Appendix 4.

## **B Summary of Findings**

In summary, small business taxpayers in this study had relatively more negative than positive relational experiences with the IRD. A majority of the business taxpayers in this study had not received fair, respectful, and neutral treatment from the IRD, which led to higher tax compliance costs and unfavourable tax perceptions. The unfavourable perceptions of the IRD have encouraged some small businesses to participate in the cash economy:<sup>90</sup>

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<sup>89</sup> Ibid; Yong and Cheng, above n 87.

<sup>90</sup> Noble, above n 34; Cash Economy Task Force, *The Cash Economy Under the New Tax System: Report to the Commissioner of Taxation*. (Commonwealth of Australia, 2003); Morse, Karlinsky and Bankman, above n 27.



People would be more encouraged if they are given incentives to want to do work for the IRD. The IRD is like a big brother who is bullying, bullying all the time and you don't want to do anything nice for him but you want to take as much from him as you can when they are not looking sort of thing. Because they are horrible and you try to take and steal their lunch or whatever and that is the scenario and that is the picture and that is how I feel. (SB 34 — Pacific male.)

Because the IRD is quite strict with the recording and small businesses have to make sacrifices in some ways. So in order to compensate them for the sacrifices, cash jobs would help. (SB11 — Asian female.)

The lack of fair, consistent, and neutral processes and decisions applied to small businesses by the IRD has caused small business taxpayers to avoid direct contact with the IRD. There are three main reasons for this. First, the IRD, being in authority, projects itself to be always correct. Second, the IRD has been shown to wield its powers on small businesses to comply at all cost. Third, the IRD gives little to no consideration to the circumstances faced by small businesses. Consequently, small business taxpayers preferred tax assistance from their accountants and peers:

Not many people will be comfortable to deal with the IRD. This is because if you ask anything else, you will probably be lumped with more tax especially if you say the wrong things. There is always the perception that the IRD is always right and I know none of my friends would be comfortable to ring up the IRD. The perception of the IRD is that they are like a blood hound, more like a policeman. They always seem to find that it is never enough. (SB3 — Asian female.)

The government and the IRD is putting a lot more onus back on the small business taxpayers ... and if they do not do them properly, they will be fined by the IRD. (BE15 — European business advisor.)

Given the above, it is important for tax authorities to adopt procedural fairness when dealing with small businesses. Unfair and inconsistent procedures used by tax authorities had resulted in tax resistance by small businesses. Continued resistance from small business taxpayers would be detrimental to the integrity of any tax system as tax burdens would fall more heavily on other taxpayers.

The findings from this study contribute to the knowledge that there is a need for tax authorities to adopt procedural justice principles towards small businesses. Fair, honest, consistent, and neutral procedures should be considered by tax authorities when managing small business taxpayers. In addition, the rights of taxpayers should be respected in order to encourage voluntary compliance and favourable perceptions of tax authorities. These measures may result in greater cooperation from small businesses and can potentially assist in combating the cash economy, which is rife amongst small businesses.<sup>91</sup>

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<sup>91</sup> Cash Economy Task Force, above n 90; Morse, Karlinsky and Bankman, above n 27.

## VI CONCLUSIONS AND SUGGESTIONS FOR FUTURE RESEARCH

The accounts given by the participants in this study attest to the relational experiences they had with the IRD. The findings from this study contribute additional knowledge to the tax literature. In this case, the author found that small business taxpayers' perceptions of tax authorities are influenced by their relational experiences with the tax authority and the processes undertaken by the tax authority when making decisions about them during audits. Furthermore, disrespectful, intimidating, and judgemental representatives of the tax authority created a culture of fear and resistance from small businesses which led to increased compliance costs and participation in the cash economy.

In order to encourage voluntary compliance amongst small businesses, tax authorities need to adopt fair procedures to create environments conducive to small businesses *wanting to comply* rather than *having to comply*. Regulating small businesses using procedural justice principles involves tax officers being more customer-focussed towards taxpayers by being unbiased, supportive, and respectful. The purpose of the audit-query by the IRD should be to prioritise education of taxpayers so that they will keep proper records and declare correct taxable incomes. Audits can be used as a powerful relationship-building tool with taxpayers, as well as functioning as a deterrent for tax cheating. It is necessary and critical for tax authorities to consider procedural justice principles when managing taxpayers, as these benefit the IRD in terms of lower monitoring costs and lower tax compliance costs for the taxpayers.

Despite the small sample size,<sup>92</sup> which is common for qualitative interview based research on small businesses,<sup>93</sup> the richness and depth of the data obtained has provided multiple views of taxpayers' perceptions towards the tax authority. Patton argues that a qualitative study sample 'only seems small' in comparison with the sample size needed for representativeness when the purpose is generalising from a sample to the population of which it is a part.<sup>94</sup> Consequently, qualitative inquiry samples are often mistakenly judged on 'logic and purpose of probability samples instead of being judged according to the purpose and rationale of the study.'<sup>95</sup> In this study, 'the validity, meaningfulness, and insights generated from qualitative inquiry have more to do with the information richness of the cases selected than with sample size.'<sup>96</sup>

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<sup>92</sup> Patton, above n 65, 244.

<sup>93</sup> For example, 30 small business taxpayers were interviewed in Margaret McKerchar, Helen Hodgson and Michael Walpole, 'Understanding Australian Small Businesses and the Drivers of Compliance Costs: A Grounded Theory Approach' (2009) 24(1) *Australian Tax Forum* 39. Another 12 small businesses participated in the interview based research section of an Australian study undertaken by Philip Lignier, 'The Managerial Benefits of Tax Compliance: Perception by Small Business Taxpayers' (2009) 7(2) *eJournal of Tax Research* 106.

<sup>94</sup> Patton, above n 65, 244.

<sup>95</sup> Ibid 245.

<sup>96</sup> Ibid.

All research, including this study, is not without limitations. As this study relied on the theoretical and snowballing sampling processes, saturation<sup>97</sup> was reached at 36 specific taxpayers-participants, which in this case were drawn from Auckland, New Zealand. The limitations of these sampling processes include selecting participants who, in the opinion of the researcher, are relevant to the study<sup>98</sup> and are purposefully selected to illuminate the phenomenon under study.<sup>99</sup> These limitations have been minimised by data triangulation as mentioned in Part IV.A.4 of this paper.

Further research from other regions and countries with similar self assessment tax regimes, such as Australia, United Kingdom, United States, Canada, and Western Europe could replicate this study to confirm or refute the existing findings regarding the impact of procedural justice on tax perceptions. The research could also be extended using the survey method to determine whether the existing proposition holds for other taxpayers.

More research on small businesses is needed in order for tax regulators, academics, policy makers, and the business community to understand how small businesses comply with tax regulations. All need to be informed of the types of regulatory strategies suitable for small businesses and such strategies should be customised to enhance the voluntary compliance necessary for the effectiveness of any tax system.

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<sup>97</sup> Denzin and Lincoln, 'Introduction: Entering the Field of Qualitative Research', above n 61; Patton, above n 65; Neuman, above n 64.

<sup>98</sup> Sarantakos, above n 60, 164;

<sup>99</sup> Patton, above n 65, 243.

## APPENDICES

### **Appendix 1: Selected interview questions for small business taxpayers relevant for this study**

- (a) What kind of business are you in and how long have you been in the business?
- (b) Tell me what is like to be a small business operator in New Zealand?
- (c) When the phrase 'tax compliance' is mentioned, what kind of image(s) or word(s) come to mind?
- (d) Have you or your peers experience any tax audit or query from the IRD? Can you please tell me what was it like with that query/audit?
- (e) If you are unsure about any tax issue, to whom do you speak? Why?
- (f) Can you please tell me something about your view of the IRD to assist you with tax compliance?

### **Appendix 2: Selected interview questions for tax practitioners relevant for this study**

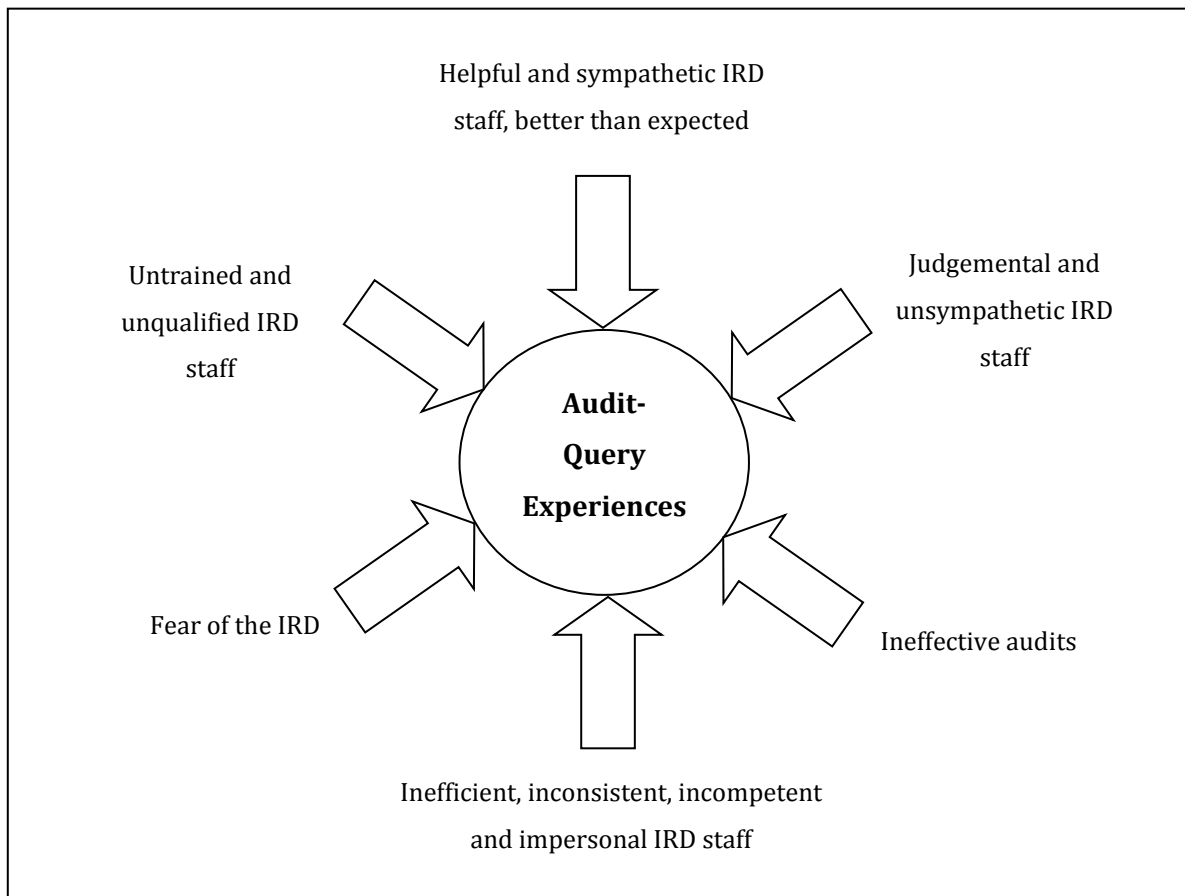
- (a) How long have you been in the accounting business and what types of services do you offer?
- (b) Tell me some of the reasons why small businesses come to you.
- (c) What do you think 'tax compliance' entails for the SME operators?
- (d) From your experience, is there any tax compliance issue(s) that is/are distinct to small business taxpayers?
- (e) Do you handle any IRD audit inquiries relating to your clients and why? Tell me your experience with the IRD audit.

### **Appendix 3: Selected interview questions for business experts relevant for this study**

- (a) Can you please tell me your role and your involvement with small businesses in New Zealand?
- (b) From your involvement with small businesses, what do you think is the general perception of small businesses towards tax compliance?
- (c) Why do small businesses perceive it as such?
- (d) How do small businesses manage their tax compliance process?
- (e) Can you please tell me your observation of small businesses and how they address these issues:
  - (i) Managing competing demands on their business resources
  - (ii) Interacting and their perceptions of the IRD

**Appendix 4: Summary of taxpayers' experiences with the IRD**

**Diagram: Audit-Query Experiences of Small Business Taxpayers in Auckland**





**A SUPER MASSIVE 'BLACK HOLE'?  
THE TAX TREATMENT OF SEISMIC STRENGTHENING COSTS**

ANDREW J MAPLES\*

**ABSTRACT**

On 4 September 2010, an earthquake of magnitude ('M') 7.1 on the Richter scale rocked the Canterbury region. This has been followed by thousands of aftershocks, including the deadly M6.3 earthquake on 22 February 2011, which struck at a shallow depth near central Christchurch. The aftershocks have caused significant damage to property and buildings. A large number of typically older New Zealand buildings require earthquake strengthening to meet the current building code, in many cases at significant cost. It is expected that the building code will tighten in the future. This article considers the limited judicial authority on whether costs to strengthen an existing building to comply with the building code will constitute deductible repairs or alterations, or capital improvements.

## I INTRODUCTION

### *A Background*

On Saturday, 4 September 2010 at 4:35 am a powerful earthquake, magnitude 7.1 on the Richter scale, struck the Canterbury region. The earthquake (and subsequent aftershocks)<sup>1</sup> caused widespread property damage. The September earthquake was followed by a far more devastating earthquake, which struck at 12:51 pm on Tuesday, 22 February 2011 and — despite its smaller magnitude (of M6.3) — killed 185 people and caused substantial damage to property and buildings.<sup>2</sup> The M6.3 earthquake was centred 10 kilometres south-east of the centre of Christchurch at a depth of only 5 kilometres. The highest peak ground (vertical) acceleration (PGA) of 2.2g (ie 2.2 times the acceleration of gravity) recorded in this earthquake is the highest PGA ever recorded in New Zealand.<sup>3</sup>

The earthquakes have caused substantial damage to property and buildings. The Reserve Bank of New Zealand has suggested the total cost of insurance claims arising from the earthquakes could be NZ\$30 billion.<sup>4</sup> It is expected that 70–80 per cent of buildings in the Christchurch central business district (CBD) will ultimately be demolished as a result of the quakes.<sup>5</sup>

The Christchurch earthquakes have led to a greater awareness in New Zealand among, inter alia, central and local government, insurers, and building owners of the potential issues associated with buildings through-out New Zealand. It is estimated, for example, that there are 4,000 unreinforced masonry buildings in New Zealand and all of them are

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<sup>1</sup> Technically, the initial M7.1 event was an earthquake and subsequent events are classed as aftershocks not earthquakes as they were caused by the initial event. This article will use the terms aftershock and earthquake interchangeably.

<sup>2</sup> The M6.3 earthquake was shortly followed by two significant aftershocks of M5.8 and M5.9. In addition to the September and February earthquakes, on 13 June 2011 two major aftershocks measuring M5.85 and M6.4 struck the region. Further damage was caused by M5.8 and M6.0 earthquakes, which hit the Canterbury region on 23 December 2011. Since the initial 4 September 2010 earthquake, there have been to date (30 October 2012) 59 earthquakes of magnitude 5 and greater: Geonet, *Aftershocks* <<http://info.geonet.org.nz/display/home/Aftershocks>>. There have been in excess of 10,844 aftershocks in total since 4 September 2010 (to 30 October 2012): *Christchurch Quake Map*, <<http://www.christchurchquakemap.co.nz/>>.

<sup>3</sup> Geonet, 'Feb 22 2011 Christchurch badly hit by M6.3 earthquake', <<http://www.geonet.org.nz/news/feb-2011-christchurch-badly-damaged-by-magnitude-6-3-earthquake.html>>. The ground accelerations in Christchurch were as much as four times higher than the highest accelerations measured in the March 2011 M8.9 earthquake off the east coast of Japan: Rong-Gong Lin II and Sam Allen, 'New Zealand quake raises questions about L.A. buildings', *Los Angeles Times* (online), (Los Angeles), 26 February 2011, <<http://www.latimes.com/news/local/la-me-quake-california-20110226.0,5641999.print.story>>.

<sup>4</sup> Alan Wood, 'Rebuild momentum hit by recent quakes', *The Press* (Christchurch), 28 January 2012, C21.

<sup>5</sup> Claire Rogers, 'Fletcher reviewing Kiwi operations', *The Press*, (Christchurch), 23 August 2012, A13. New Zealand building standards take into account the earthquake risk, with building codes requiring a building with a 50 year design life to withstand predicted loads of a 500 year event. Initial reports by GNS Science suggested ground motion in the February 2011 earthquakes 'considerably exceeded even 2500 year design motions': 'No structure built to take it', *The Gisborne Herald* (online), (Gisborne). 5 March 2011, <<http://www.gisborneherald.co.nz/article/?id=21722>>.



considered earthquake prone.<sup>6</sup> Many New Zealand buildings currently require earthquake strengthening — in many cases at significant expense — to bring them up to the *Building Act 2004* (NZ) minimum. It is expected that reviews underway (see section II of this paper) will see a further tightening of these standards, which will impose even greater demands (and costs) on building owners in respect of strengthening existing buildings.

### **B The importance of the issue**

The objective of this article is, using a traditional ‘black-letter law’ analysis approach,<sup>7</sup> to consider what the NZ law is concerning the deductibility of seismic strengthening expenditure in light of the existing case law. The view often expressed in the business pages and by commentators is that all such expenditure is on capital account and consequently non-deductible.

This issue is especially important for three related reasons. First, due to the potentially significant number of existing buildings that do not meet the current — let alone any future, more stringent — building code, many building owners will be required to expend considerable sums to bring their buildings to the requisite compliance level. Second, the recent change to building depreciation means that, with effect from 1 April 2011, a nil rate of depreciation applies for all buildings, ie in effect, owners can no longer claim depreciation on a building.<sup>8</sup> They are still able to claim depreciation deductions for fit-outs which are not considered part of the building. The denial of depreciation deductions for buildings will itself create:

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<sup>6</sup> Ben Heather, ‘September’s quake “saved 300 lives”, *The Press* (online), (Christchurch), 7 November 2011, <<http://www.stuff.co.nz/the-press/news/christchurch-earthquake-2011/5919747/Septembers-quake-saved-300-lives>>. More recently, concerns have been expressed about 1980s buildings constructed of ‘brittle’ block in Wellington: Hank Schouten, ‘How safe are the capital’s office buildings?’, *The Dominion Post* (online), (Wellington), 2 June 2012.

<sup>7</sup> Salter and Mason define the ‘black-letter law’ analysis approach as ‘a research methodology that concentrates on seeking to provide a detailed and highly technical commentary upon, and systematic exposition of, the content of legal doctrine.’: Michael Salter and Julie Mason, *Writing Law Dissertations — an Introduction and Guide to the Conduct of Legal Research* (Pearson Longman, 2007) 49. I acknowledge the limitations of this approach, including the subjective nature of interpreting and applying rules (including case law) and the dynamic nature of law: *ibid* 113. Salter and Mason contains an extensive consideration of the ‘black letter’ law approach: *ibid* 109–118. For a discussion of legal research techniques see also Peter Cane and Herbert M Kritzer (eds), *The Oxford Handbook of Empirical Legal Research* (Oxford University Press, 2010) and Margaret McKerchar, *Design and conduct of research in tax, law and accounting* (Lawbook Co, 2010).

<sup>8</sup> The nil rate applies to both commercial and residential buildings, and to rental and owner-occupied buildings, irrespective of when they were purchased or constructed. Building owners will still remain liable for the recovery of previously accumulated depreciation upon their future sale. The introduction of the nil rate followed a recommendation by the Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand’s Future: Report of the Victoria University of Wellington Tax Working Group* (2010). For a discussion of this change and its implications see Mark Keating, ‘Problems Flowing from the Nil Depreciation of Buildings’ (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 307.

a massive new category of black-hole expenditure,<sup>9</sup> with all the problems that presents ... To limit the adverse tax effect from this change, taxpayers will undoubtedly seek to recharacterise the nature of their expenditure on buildings ... in order to mitigate the tax effect of disallowing all depreciation.<sup>10</sup>

In the event that seismic strengthening costs are treated as capital improvements based on case law — and thus the expenses are capitalised to the building's cost — building owners will not be entitled to claim tax depreciation on these costs. There will be little taxation incentive, therefore, to strengthen a building. However, as indicated, to continue to satisfy current and future requirements of local councils, and demands of insurers, seismic strengthening work will be required of building owners. Finally, it is hoped that this article will also provide some valuable insight for other jurisdictions. Recent earthquakes in other countries such as Japan, Haiti, and Italy, as well as the potential for such seismic events in areas such as California, may lead to a renewed focus both on strengthening existing buildings in these zones and on the related characterisation of such expenditure from a tax perspective. The conclusions of this article, particularly with reference to 'minor' strengthening work and the treatment of mixed work, could also be applicable to such work undertaken in the interests of public safety in general in response to, for example, recommendations from engineering and geotechnical reviews of a property.

In Interpretation Statement *IS 12/03: Income Tax — Deductibility of Repairs and Maintenance Expenditure — General Principles*<sup>11</sup> ('IS 12/03'), the Inland Revenue observes that the nature of expenditure, whether characterised as repairs or something more extensive, 'does not change if the repairs are carried out as a result of a significant event, for example, fire, flood or earthquake.' The same principles are applied to determine the tax treatment of repairs arising as a result of a significant event as are applied for repairs arising for other reasons.<sup>12</sup> Accordingly, aspects of the analysis in this article potentially have wider application, for example for certain leaky home expenditure.<sup>13</sup>

The remainder of this article is arranged as follows. Section II outlines the central government response to the Canterbury earthquakes as at 30 October 2012. The legislative and case law setting for the capital-revenue distinction in New Zealand is outlined in Section III. The two New Zealand cases considering the tax treatment of seismic strengthening costs are analysed in Sections IV and V, respectively. Section VI briefly reviews IS 12/03, the Inland Revenue Department's recently released

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<sup>9</sup> Blackhole expenditure is expenditure that is not immediately deductible (if it is on capital account, for example) and cannot be deducted by way of depreciation over the life of the asset to which it relates (nor over any other period).

<sup>10</sup> Keating, above n 8, 308.

<sup>11</sup> Inland Revenue, *Income Tax — Deductibility of Repairs and Maintenance Expenditure — General Principles*, IS 12/03, (2012) 24(2) *Tax Information Bulletin* 68 ('IS 12/03').

<sup>12</sup> *Ibid* 70 [27].

<sup>13</sup> In NZ during the 1990s a considerable number of houses were built using methods that, due to problems involving design, and installation of materials, leak when it rains. In some cases the materials themselves were used inappropriately. This has led to extensive damage to the fabric and structure of many houses constructed at this time and has required substantial remediation of affected properties.

interpretation statement on repairs and maintenance. Section VII considers whether seismic strengthening may be deductible in certain circumstances. Concluding observations are made in Section VIII.

## II CENTRAL GOVERNMENT RESPONSE TO THE EARTHQUAKES

### *A The rebuild and recovery*

Initially, after the February 2011 earthquake, a national state of emergency was imposed. This was lifted on 23 April 2011. The Canterbury Earthquake Recovery Authority ('CERA') was subsequently established by the government to lead and coordinate the ongoing recovery effort following the earthquakes. Its role includes:

- Providing leadership and coordination for the ongoing recovery effort.
- Focusing on business recovery, restoring local communities and making sure the right structures are in place for rebuilding.
- Enabling an effective and timely rebuilding.<sup>14</sup>

CERA, which reports to the Minister for Canterbury Earthquake Recovery (the Minister), is also tasked with working closely with local councils and engaging with local communities, including Ngāi Tahu (the local Māori tribe), the private sector, and the business sector. Special powers have been vested in the Minister and CERA in order to 'enable an effective, timely and co-ordinated rebuilding and recovery effort.'<sup>15</sup>

With respect to the central city, in April 2012 the Central Christchurch Development Unit ('CCDU') was established within CERA and was charged with preparing a development blueprint, which will provide guidance on where public buildings and 'strategic city blocks' will be located.<sup>16</sup> The 120 page finalised blueprint — titled the *Christchurch Central Recovery Plan* ('the recovery plan') — was released to the public on 30 July 2012,<sup>17</sup> and outlines the future development of central Christchurch. The recovery plan directs the Christchurch City Council to make a series of changes to its District Plan to ensure the objectives of the Recovery Plan are met, and also requires that all people making decisions on matters covered by the *Resource Management Act 1991* (NZ) (and related statutes) must not act inconsistently with the recovery plan.<sup>18</sup>

In October 2012, CCDU announced it was close to finalising the first deals for land needed to implement the recovery plan.<sup>19</sup> In addition, an 'Invest Christchurch' service

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<sup>14</sup> Canterbury Earthquake Recovery Authority, <<http://cera.govt.nz/about-cera>>.

<sup>15</sup> Ibid.

<sup>16</sup> Central Christchurch Development Unit, <<http://ccdu.govt.nz/>>.

<sup>17</sup> Central Christchurch Development Unit, *Christchurch Central Recovery Plan* (2012), <<http://ccdu.govt.nz/the-plan>>.

<sup>18</sup> Central Christchurch Development Unit, *The Recovery Plan*, <<http://ccdu.govt.nz/faq/general>>.

<sup>19</sup> Canterbury Earthquake Recovery Authority, *Greater Christchurch Recovery Update* (October 2012), 2, <<http://cera.govt.nz/news/2012/greater-christchurch-recovery-update-issue-14-october-2012CERA>>.

has also been established by CCDU to engage with potential investors at all levels (local, national, and international).<sup>20</sup>

### **B The Building Code**

Following the 22 February 2011 Canterbury earthquake, the Department of Building and Housing ('DBH') appointed leading New Zealand engineering consultants to undertake a technical investigation of the performance of four relatively modern multi-storey buildings in the CBD where there had been serious structural failures. The four buildings were the Canterbury Television ('CTV'), Pyne Gould Corporation ('PGC'), Forsyth Barr, and Hotel Grand Chancellor buildings. An Expert Panel oversaw their work and peer reviewed their findings, which are available on the DBH website.<sup>21</sup>

In March 2012, DBH announced the review of the earthquake-prone building policy framework established under the *Building Act 2004* (NZ).<sup>22</sup> The review will consider, inter alia, whether current regulatory requirements are adequate (ie existing buildings have to meet one third of the new build standard requirements) and whether there should be regulations specifying the level(s) of upgrade required of earthquake-prone buildings. One of the main outputs of the review, which will be informed by the Royal Commission's findings (see following paragraphs), is expected to be a Building Amendment Bill, with the regulatory changes to be passed in May 2013.

A Royal Commission was established on 14 March 2011 to inquire into the Canterbury Earthquakes, and is chaired by Justice Mark Cooper, a sitting New Zealand High Court judge.<sup>23</sup> The purpose of the Royal Commission is to examine issues around the built environment in the Christchurch CBD, including, but not limited to, the four buildings already mentioned in this section, and to consider the adequacy of the relevant building codes and standards.

Part One of the Royal Commission Final Report,<sup>24</sup> containing 70 recommendations intended to inform early decision-making about the central city's recovery from the Canterbury earthquakes, was released to the public on 23 August 2012. The recommendations 'focus on technical engineering issues, including seismicity, recommendations to change concrete structures, structural steel and earthquake actions standards, providing guidance or training to structural engineers and low-damage

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<sup>20</sup> Ibid 2.

<sup>21</sup> Ministry of Business, Innovation and Employment, *Canterbury Earthquakes — Investigation Reports* (2012), <<http://www.dbh.govt.nz/canterbury-earthquake-technical-investigation>>.

<sup>22</sup> Ministry of Business, Innovation and Employment, *Terms of reference — Earthquake-prone building policy review* (March 2012), <<http://www.dbh.govt.nz/epb-terms-of-reference>>.

<sup>23</sup> Canterbury Earthquakes Royal Commission, <<http://canterbury.royalcommission.govt.nz/>>.

<sup>24</sup> Part One of the Royal Commission Final Report is comprised of the following three volumes: New Zealand, Canterbury Earthquakes Royal Commission, *Volume 1 Summary and Recommendations in Volumes 1–3, Seismicity, Soils and the Seismic Design of Buildings* (2012); New Zealand, Canterbury Earthquakes Royal Commission, *Volume 2 The Performance of Christchurch CBD Buildings* (2012); New Zealand, Canterbury Earthquakes Royal Commission, *Volume 3 Low-Damage Building Technologies* (2012).

building technologies.<sup>25</sup> Some of the recommendations, which align with the DBH technical investigation referred to above, have already been implemented.<sup>26</sup>

Further volumes, including those covering quake-prone building policy, will be delivered in the coming months. The Royal Commission's final report will be delivered no later than 30 November 2012.<sup>27</sup> In addition, as part of the inquiry into the failure of buildings in the Canterbury earthquakes, the Royal Commission conducted a public hearing about the CTV building collapse, where 115 lives were lost.

The government expects to issue a 'full and comprehensive' response to the Royal Commission's complete findings in early 2013.<sup>28</sup>

### ***C The need for central government intervention?***

Due to the limited judicial authority on seismic strengthening costs and (now) the nil depreciation rate for buildings, a number of commentators have called for government intervention in this area.<sup>29</sup> The Property Council has requested:

the Government to fix the 'dreadful mistake' of removing tax depreciation on commercial property. It also said earthquake strengthening must be made tax-deductible. 'There's no incentive now for bringing buildings up to earthquake standards, and that affects all our cities, not just Christchurch.'<sup>30</sup>

This comes at a time when there have also been calls for incentives, such as accelerated depreciation on plant, to encourage businesses to commit to Christchurch.<sup>31</sup>

The Minister of Revenue, The Hon Peter Dunne, in announcing the government tax policy work programme for 2012-13, made reference to issues concerning blackhole expenditure, but in the context of certain fixed life resource consents and company administration costs.<sup>32</sup> Due to fiscal constraints, consideration of other forms of blackhole expenditure, such as the amortisation of capital raising costs, are not included in the work programme.<sup>33</sup> No reference is made in the speech to the 'black hole' of

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<sup>25</sup> Marc Greenhill, 'Report will influence construction — minister', *The Press* (online), 23 August 2012, <<http://www.stuff.co.nz/the-press/news/7535537/Report-will-influence-construction-minister>>.

<sup>26</sup> Ibid.

<sup>27</sup> Canterbury Earthquakes Royal Commission, above n 23.

<sup>28</sup> Greenhill, above n 25.

<sup>29</sup> International accounting firm PWC believes that tax relief is required from a social policy/public benefit perspective: PWC, *Facts on Tax 2011 Series 2 Suggested Solutions* (2011), 12. See also 'Calls for earthquake strengthening costs to be depreciable', *Landlords For Kiwi Property Investors* (online), 16 September 2011, <[http://www.landlords.co.nz/read-article.php?article\\_id=4043](http://www.landlords.co.nz/read-article.php?article_id=4043)>.

<sup>30</sup> Liz McDonald, 'Rebuild "at risk" in new city plan', *The Press* (Christchurch), 8 February 2012, A1.

<sup>31</sup> Tamlyn Stewart, 'Coca-Cola plant expands in Christchurch', *Fairfax NZ News* (online), 18 January 2012, <<http://www.stuff.co.nz/business/rebuilding-christchurch/6276345/Coca-Cola-plant-exp>>.

<sup>32</sup> The Hon Peter Dunne, 'Address to IFA annual conference' (Speech delivered at the IFA Annual Conference, Queenstown, 16 March 2012) 7-8 <<<http://taxpolicy.ird.govt.nz/news/2012-03-16-new-tax-policy-work-programme-announced-speech>>. The work programme is available at Inland Revenue, *Government tax policy work programme for 2012-13* (16 March 2012), <<http://taxpolicy.ird.govt.nz/work-programme>>.

<sup>33</sup> Dunne, above n 32, 8.

seismic strengthening costs — quite possibly for similar fiscal reasons. Further, the reference in the Minister's speech to the Canterbury earthquakes does not mention this issue.<sup>34</sup> More recently, the Minister's speech to the 2012 NZICA<sup>35</sup> Annual Tax Conference<sup>36</sup> contains no reference to this matter.

### III THE STATUTORY AND CASE LAW SCHEME

#### A *The Income Tax Act*

Section DA 1(1) of the *Income Tax Act 2007* (NZ) — called the 'general permission' — allows a deduction for an amount of expenditure or loss incurred in deriving assessable income or carrying on a business for the purpose of deriving assessable income. The *Income Tax Act 2007* (NZ) applies from the beginning of the 2008-09 income year.<sup>37</sup> The equivalent provisions in the earlier Income Tax Acts considered in the cases analysed in this article were *Income Tax Act 1994* (NZ) s BD 2(1) and *Income Tax Act 1976* s 104 ('the earlier acts').

Section DA 1 *Income Tax Act 2007* (NZ) is subject to the general limitations in s DA 2 of that Act, including the 'capital limitation' (*Income Tax Act 2007* (NZ) s DA 2(1)), which denies a deduction for an amount of expenditure or loss to the extent it is of a capital nature. The equivalent capital prohibitions in the earlier acts were *Income Tax Act 1994* (NZ) s BD 2(2)(e) and *Income Tax Act 1976* (NZ) s 106(1)(a), respectively. Deductions for repairs and maintenance are dealt with under the general permission and are subject to the general limitations.<sup>38</sup>

For the purposes of this article the wording of ss DA 1 and DA 2(1) *Income Tax Act 2007* (NZ) have essentially remained unchanged from the earlier acts; hence, case law (and related Inland Revenue statements) on the interpretation of the equivalent sections in the earlier acts are still applicable.

#### B *The judicial view*

The term 'capital' is not defined in the *Income Tax Act 2007* (NZ), nor in earlier tax acts. The courts have developed a series of indicative tests for distinguishing between capital

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<sup>34</sup> Ibid 9.

<sup>35</sup> New Zealand Institute of Chartered Accountants (NZICA).

<sup>36</sup> The Hon Peter Dunne, 'Keynote Address to NZ Institute of Chartered Accountants (NZICA) 2012 Tax Conference' (Speech delivered at NZICA Annual Tax Conference, Auckland, 26–27 October 2012), <<http://taxpolicy.ird.govt.nz/news/2012-10-26-speech-nzica's-20th-annual-tax-conference-speech>>.

<sup>37</sup> The *Income Tax Act 2007* (NZ) represents the final stage of the rewrite (and reorganisation) of the New Zealand income tax legislation.

<sup>38</sup> In the *Income Tax Act 1976* (NZ) repairs and maintenance expenditure was governed by a separate provision (s 108). That section allowed a deduction for repairs and maintenance expenditure up to the amount usually expended in any year for repairs. Beyond that, the second proviso of s 108 provided a deduction if 'the Commissioner is satisfied that any repairs or alterations of any such asset do not increase the capital value of the asset, or that the repairs or alterations increase that value by an amount less than the cost of the repairs or alterations ...'. Section 108 was not re-enacted with the passing of the *Income Tax Act 1994* (NZ).

and revenue expenditure. In New Zealand, the 'governing approach is exemplified in the observations of Lord Pearce'<sup>39</sup> in *BP Australia Limited v FCT* [1966] AC 224 ('*BP Australia*'), including:

The solution to the problem [of distinguishing between capital and revenue] is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other ... [T]he line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

'depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process'

(per Dixon, J. in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at p 648).<sup>40</sup>

The passage Lord Pearce quoted from *Hallstroms Pty Ltd v Federal Commissioner of Taxation* is hereafter referred to as the '*Hallstroms test*'.

The leading New Zealand authorities on the treatment of repairs and maintenance and capital improvements are the Supreme Court (now the New Zealand High Court)<sup>41</sup> decision in *Auckland Trotting Club (Inc) v CIR* [1968] NZLR 193 ('*Auckland Trotting (SC)*') and the New Zealand Court of Appeal decision in *Auckland Trotting Club (Inc) v CIR* [1968] NZLR 967. Moller J in the Supreme Court (affirmed on appeal), outlined a two step analysis to determine whether the work undertaken is a 'repair' or 'alteration', or something more.<sup>42</sup> The first step is to identify the relevant asset upon which the work has been done.<sup>43</sup> The second step is to consider the nature and extent of the work done on the asset.<sup>44</sup> Expenditure incurred to repair or maintain an asset 'without changing its character'<sup>45</sup> will be on revenue account. If the work undertaken on the asset results in the reconstruction, replacement, or renewal of the asset, or substantially the whole of the asset, the work will amount to capital expenditure. Lord Nicholls in the Privy Council decision in *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702, 15,706 ('*Auckland Gas (PC)*') observed that the words 'repair' and 'replacement' 'are not technical expressions with a special meaning' but bear an ordinary, everyday meaning.<sup>46</sup>

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<sup>39</sup> *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9 101, 9 103.

<sup>40</sup> *BP Australia* [1966] AC 224, 264-5.

<sup>41</sup> The Supreme Court was renamed the High Court in 1980 and is not to be confused with the new Supreme Court, which, since 2004, is New Zealand's final court of appeal, replacing the Privy Council in that function.

<sup>42</sup> *Auckland Trotting (SC)* [1968] NZLR 193, 201.

<sup>43</sup> See generally Inland Revenue, IS 12/03, above n 11, 69 [10]-[12].

<sup>44</sup> See generally Inland Revenue, IS 12/03, above n 11, 70 [16]-[27].

<sup>45</sup> *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] 115 CLR 58, 72 ('*W Thomas & Co*').

<sup>46</sup> See generally Andrew Maples, 'Case note. The Distinction between Repairs and Replacement Revisited, *Auckland Gas Company Limited v Commissioner of Inland Revenue* (Privy Council)' (2001) 2 *British Tax Review* 92; Andrew Maples, 'Beware Technological Developments: A New Zealand Perspective on Repairs and Replacement' (2001) 30(3) *Australian Tax Review* 173.

#### IV COLONIAL MOTOR COMPANY LTD v CIR.<sup>47</sup>

##### *A The facts*

In this case, the taxpayer company, Colonial Motor Company ('CML'), owned a 60 year old, eight storey building in Courtenay Place, Wellington. By the 1970s, the building, which had originally been used as a motor assembly plant for Ford motorcars, was an earthquake risk and the Wellington City Council ('WCC') required its demolition or strengthening by 1988. In 1981, the company's directors considered five options, adopting the fifth, ie 'Reinstate building as acceptable to Earthquake Seismic Code and Refurbish building for 50 year life'.<sup>48</sup> The Managing Director noted, in respect of the work to be undertaken to the then partially vacant building: 'Strengthening becomes *equivalent of [a] new building* — say 50 years future life — for half the costs of a new building.'<sup>49</sup> (Emphasis added.)

The company undertook extensive seismic strengthening work, including the construction of two internal reinforced concrete shear walls from ground floor to sixth floor ('an entirely new structural addition')<sup>50</sup> and the installation of diagonal steel bracing on the seventh and eighth floors. In addition, CML added a ninth floor penthouse. As a result, the building was transformed from a warehouse type structure with a value of NZ\$1.6 million into an office building with a government valuation of NZ\$16.5 million.

The total cost of the work, which was expended over five tax years (1984–88), was NZ\$5.7 million. The expenditure was divided into three categories: seismic strengthening (NZ\$1.28 million), repairs (NZ\$942 706), and capital (NZ\$3.47 million). At issue was the first category of expense. CML claimed a deduction for the NZ\$1.28 million strengthening costs on the basis that they were repairs and alterations and did not increase the capital value of the building. The Commissioner of Inland Revenue ('the Commissioner') denied the deduction on the basis, first that the work was not repairs or alterations but capital expenditure;<sup>51</sup> and second that the work increased the value of the building by more than the cost of the work.<sup>52</sup> In the High Court, Ellis J concluded that the seismic strengthening was an integral part of the overall expenditure,<sup>53</sup> and the work in its entirety had substantially increased the building's capital value and therefore could not be characterised as alterations. The taxpayer appealed to the New Zealand Court of Appeal.

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<sup>47</sup> *Colonial Motor Company Ltd v CIR* (1994) 16 NZTC 11 060, 11 061 (*Colonial Motors* (HC)).

<sup>48</sup> *Ibid* 11 061.

<sup>49</sup> *Colonial Motor Company Ltd v CIR* (1994) 16 NZTC 11 361, 11 363 (*Colonial Motors* (CA)).

<sup>50</sup> *Ibid* 11 366.

<sup>51</sup> *Income Tax Act 1976* (NZ) s 106(1)(a).

<sup>52</sup> *Income Tax Act 1976* (NZ) s 108 (second proviso).

<sup>53</sup> *Colonial Motors* (HC) (1994) 16 NZTC 11 060, 11 063.



## **B The New Zealand Court of Appeal**

The comparatively short judgment of the New Zealand Court of Appeal was delivered by Richardson J. His Honour confirmed Ellis J's finding in the NZ High Court that there was one overall construction project and it had to be considered as such;<sup>54</sup> to be deductible the total work undertaken on the building would have had to constitute repairs or alterations. On the facts in this case, the work 'could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work'.<sup>55</sup> The allocation of the total expenditure to different categories did not change the character of the expenditure: 'It was a *single project* which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50-year revenue earning life.'<sup>56</sup>

The Court briefly considered, based on an assessment of work undertaken both inside and outside the building, whether the work was 'alterations' or 'repairs and alterations'. Richardson J concluded that the work was an entirely new structural addition, and rejected as an oversimplification the taxpayer's submission that nevertheless it was the same building: 'What was done was a substantial reconstruction and improvement of the original premises.'<sup>57</sup> The Court had sympathy with Inland Revenue's argument that the work went beyond alterations and changed the building's character. However, ultimately the Court concluded it did not need to decide this matter as the work undertaken on the building failed to meet the second proviso of s 108 of the *Income Tax Act 1976* (NZ) on the basis that it had increased the building's capital value by more than the cost of the work and was therefore on capital account.

## **V TRA CASE X26**

### **A The facts**

The taxpayer in *TRA Case X26* (2006) 22 NZTC 12 315 was a member of a two person partnership which owned a 100 year old building in Wellington. The partners were advised by the Wellington City Council in a letter of 18 March 1999 that the building failed to comply with the earthquake strength capacity required by the relevant 1965 Loading Code. The conclusion was that the building might collapse in a moderate earthquake. The letter advised that under the *Building Act 1991* (NZ) the WCC could barricade the building and give notice for the owner to reduce or secure any danger within a specified period of time. The policy of the WCC was to allow property owners some time to remedy any defects before invoking its powers under that Act.<sup>58</sup> As the

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<sup>54</sup> 'This was despite the fact that the dispute only concerned the expenditure on the seismic strengthening and not the expenditure that the Commissioner and the taxpayer had already agreed was either revenue and deductible or capital and non-deductible.' Inland Revenue, IS 12/03, above n 11, 96 [187].

<sup>55</sup> *Colonial Motors (CA)* (1994) 16 NZTC 11 361, 11 366.

<sup>56</sup> *Ibid* (emphasis added).

<sup>57</sup> *Ibid*.

<sup>58</sup> Judge Barber accepted that in fact the WCC never directly threatened to barricade the building and that local authorities are reluctant to close down the letting of buildings because of the need for seismic strengthening: *TRA Case X26* (2006) 22 NZTC 12 315, 12 326.

building was a 'heritage property', the partners were entitled to financial assistance from the WCC to undertake the earthquake strengthening.

A report to the partnership by consulting engineers in October 1999 recommended remedial work be carried out, including the installation of a new structural steel and concrete frame towards the front of the building and a steel frame into the rear brick wall, as well as the addition of new steel in the floor bracing and wall/floor trim. This work was carried out at a total cost of NZ\$107 210.45. The WCC provided NZ\$45 000 as financial assistance and the partnership paid the balance. The work was expected to take six to eight weeks to complete but ultimately took about 12 weeks.<sup>59</sup> The building remained operational during the strengthening work.

The partnership claimed a deduction under *Income Tax Act 1994* (NZ) s BD 2(1) for the net cost of the strengthening work on the basis it constituted repairs and maintenance. Inland Revenue considered that the work was on capital account as it went beyond the repair and maintenance of the existing asset and resulted in a better asset than previously existed. Inland Revenue adjusted both the partnership returns and the two partners' assessments to reflect this conclusion. One partner disputed the adjustment. The case was heard by the Taxation Review Authority ('TRA') in its small claims jurisdiction.

## **B The findings of the Taxation Review Authority**

### **1 The small claims jurisdiction of the TRA**

A TRA is a one member authority<sup>60</sup> 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, and is governed by the *Taxation Review Authorities Act 1994* (NZ). Prior to 29 August 2011, every TRA had two levels of jurisdiction — general and small claims.<sup>61</sup> A major difference between the two jurisdictions is that, unlike the TRA's general jurisdiction, findings of the small claims jurisdiction have no precedential effect,<sup>62</sup> other than for the affected taxpayer.<sup>63</sup> The decision of Judge Barber therefore technically has no precedential value, which is disappointing given the lack of judicial authority in this area. However, due to the paucity of case law on the matter, the case will effectively act as de facto precedent, especially as the reasoning and approach

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<sup>59</sup> There was suggestion in the case that in fact the work took only seven weeks and the engineers billed for the work over a four month period: *ibid* 12 326.

<sup>60</sup> *Taxation Review Authorities Act 1994* (NZ) s 3.

<sup>61</sup> A taxpayer's right to elect for their dispute to be heard in the small claims jurisdiction was removed with effect from 29 August 2011. Taxpayers could elect to have a tax dispute heard in the small claims jurisdiction where: the facts were clear and not in dispute, there were no 'significant legal issues' involved and the tax to pay did not exceed NZ\$30 000: *Tax Administration Act 1994* (NZ) s 13B(1) (now repealed). Somewhat curiously, and despite observing the small claims jurisdiction 'seems inappropriate' because the case involved significant legal issues for the taxpayer, Judge Barber agreed to deal with *TRA Case X26* under the small claims jurisdiction — rather than transferring it to the TRA's general jurisdiction: *TRA Case X26* (2006) 22 NZTC 12 315, 12 316. It is also of some note that the Inland Revenue apparently did not seek to have the case transferred to either the general jurisdiction of the TRA or the High Court.

<sup>62</sup> *Taxation Review Authorities Regulations 1998* (NZ) reg 18(5).

<sup>63</sup> *Taxation Review Authorities Regulations 1998* (NZ) reg 18(6).

adopted by the TRA in *TRA Case X26* clearly follows (and applies) *Colonial Motors (CA)*, which in turn applies principles established in leading capital–revenue cases. In addition, Judge Barber in *TRA Case X26* considered a number of arguments which were not raised in *Colonial Motors (CA)*. For these reasons I would expect that taxpayers and Inland Revenue will use relevant aspects of *TRA Case X26*, along with *Colonial Motors (CA)*, to support their respective positions with regards the tax treatment of seismic strengthening expenses, both in the pre-litigation (dispute resolution) phase and litigation phase itself.

This expectation concerning *TRA Case X26* is supported by the view of the Inland Revenue. IS 12/03 acknowledges that as the case was decided under the TRA's small claims jurisdiction it is therefore 'of *limited precedential value* given the level of jurisdiction' (emphasis added).<sup>64</sup> However, the statement adds that Inland Revenue 'considers the correct approach to the application of the capital/revenue tests was adopted in this decision.'<sup>65</sup>

## 2 *Expenditure on capital account*

At the commencement of his judgment, Judge Barber stated that the expenditure undertaken on the building was clearly on capital account.<sup>66</sup> It was undertaken to create advantages of a lasting character which improved an identifiable asset (the building) as part of the partnership's income-earning structure (as distinct from its income-earning process). Applying the *Hallstroms* test, Judge Barber stated that, from a practical and business point of view, the project was intended to make a major alteration to the structural integrity of the building so that it would meet the relevant statutory requirements:

Prior to the project the building, according to the disputant's own engineer: 'has a capacity less than 50% of the 1965 code ... and that the building may collapse in a moderate earthquake ....' The project was 'to achieve full compliance ... in terms of applied loadings'. ... Accordingly, the project did not merely maintain or repair the property but substantially improved it: going from less than 50 per cent earthquake strength compliance to full compliance. The end result was a substantially improved property.<sup>67</sup>

If the strengthening work had not been undertaken and the building had been barricaded by the WCC, it would have effectively become useless and taken away the partnership's income earning structure:

There was work undertaken to improve the building's earning-capacity by making it earthquake code-compliant and thus avoiding the sterilisation of the asset. While the work in this case was to make the building earthquake-code compliant, it ensured the continued

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<sup>64</sup> Inland Revenue, IS 12/03, above n 11, 83 [109]. In my view it would have been preferable had the statement referred to *TRA Case X26* as being persuasive.

<sup>65</sup> *Ibid.*

<sup>66</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 319.

<sup>67</sup> *Ibid* 12 320 (emphasis in original).

availability of the asset as part of the income-earning structure of the taxpayer's partnership.<sup>68</sup>

Judge Barber followed *Colonial Motors (CA)* even though 'in the present case the work undertaken was not as extensive as that' undertaken in *Colonial Motors (CA)*.<sup>69</sup> In both cases, *Colonial Motors (CA)* and that before him, from a practical and business point of view, the total work undertaken transformed an unsound building with a limited or possibly non-existent revenue generating capacity into a sound building capable of earning income. The finding that the expenditure was on capital account was supported by the total cost of the strengthening work as a proportion of the valuation of the property, and evidence that the work increased the capital value of the building.

Judge Barber rejected arguments that the costs were incurred to undertake deferred repairs and maintenance, which were no more than accumulated repairs and thus of a revenue nature. Unlike *Odeon Associated Theatres Ltd v Jones* [1972] All ER 681 (*Odeon Theatres*) there were no restrictions preventing normal repair and maintenance from occurring. In addition, the effect of the strengthening in *TRA Case X26* was not merely to maintain the building, but also to improve its structure dramatically, and hence, unlike the work in *Odeon Theatres*, it was not repair work.

Judge Barber also distinguished the High Court decision of *Sherlaw v CIR* (1994) 16 NZTC 11 290, 11 291 (*Sherlaw*), where the owner of a boat-shed sought to repair its slipway, floor, and piles.<sup>70</sup> Having commenced this work, some of the repairs became a much larger undertaking than anticipated (including replacing a substantial part of the roof),<sup>71</sup> and it was decided to do other deferred maintenance. In *Sherlaw*, the work did not change the dimensions of the building. The work carried out was held to be on revenue account, although in my view the case sat right on the capital–revenue border. Judge Barber noted that the decisive factor in *Sherlaw* was that, unlike *TRA Case X26*, the work undertaken was not a consequence of a single pre-determined plan to improve the asset; rather, the taxpayer had chosen to repair the boat-shed and, as a result of that decision, he was faced with consequential repair work and upgrading.

Finally, Judge Barber observed that the fact that the strengthening work undertaken by the taxpayer was a statutory requirement was irrelevant to determining the character of the expenditure.

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<sup>68</sup> Ibid.

<sup>69</sup> Ibid 12 323.

<sup>70</sup> The case bears some similarity to the Australian case *Lindsay v FCT* (1961) CLR 307, where the taxpayer was denied a deduction due to the extensive nature of the work undertaken. The case concerned a taxpayer who was a member of a partnership that carried on the business of ship repairing in premises that included two slipways. One of the slipways, which was constructed mainly of timber, was replaced with concrete because timber was unavailable. The resultant slipway was longer than the original one although this did not result in greater efficiency. During the course of the work, substantially the whole of the slipway had been demolished and replaced. As a consequence, the High Court of Australia held the work constituted the replacement of the slipway, which was an entirety in its own right and not a subsidiary part of some other asset.

<sup>71</sup> The repiling work caused the roof and the floor of the boat-shed to be substantially damaged; hence the work required on those components of the building.

## VI THE INLAND REVENUE INTERPRETATION STATEMENT

### *A General overview*

Inland Revenue Interpretation statement IS 12/03 deals with the deduction of costs incurred by a taxpayer to repair or maintain their property. It contains a useful flowchart that helpfully summarises Inland Revenue's process of analysis with respect to the capital limitation,<sup>72</sup> and includes references to seismic strengthening work (along with one specific, worked example) and discussion of *Colonial Motors* (CA) and *TRA Case X26*. One of the reasons specified for issuing the new interpretation statement (replacing a five page 1994 statement) was the Christchurch earthquakes.<sup>73</sup>

There is no specific section of the interpretation statement dedicated to such expenditure. Initially this is perhaps a little surprising given that it is published after the 2010 and 2011 Christchurch earthquakes and at a time when there is a heightened awareness nationally of building safety issues. However, the interpretation statement makes it clear that:

The nature of the expenditure does not change if the repairs are carried out as a result of a significant event, for example fire, flood or earthquake. The same principles must be applied to repairs arising as a result of a significant event as are applied to repairs arising for other reasons (*TRA Case F67*).<sup>74</sup> *The focus is on the work done.*<sup>75</sup> (Emphasis added.)

Inland Revenue's view is therefore that the income tax treatment of seismic strengthening work (and expenditure) requires an application of general case law principles. While this is correct, given the scale of strengthening work required to New Zealand buildings in the future, and the significant cost of that work in many cases, greater certainty over the location of the capital-revenue boundary line — perhaps through a series of worked examples in IS 12/03 on the point — would have been useful.

Example 17 in IS 12/03 does consider earthquake strengthening work. No case law is mentioned in this example, nor any of the other examples outlined in the statement. The example,<sup>76</sup> which is arguably broadly based on *Colonial Motors* (CA), concerns an older commercial building which requires earthquake strengthening work to comply with council requirements for buildings of that type. The building owner 'decides that the building would benefit from a complete refurbishment, including structural changes that will extend the floor plan and enhance the common areas as well as earthquake-

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<sup>72</sup> Inland Revenue, IS 12/03, above n 11, 71 [35].

<sup>73</sup> Ibid 71 [28]. Other reasons included new case law, such as *Auckland Gas* (PC), and the change to building depreciation: ibid 71 [28].

<sup>74</sup> In *TRA Case F67* (1983) 6 NZTC 59 897, the taxpayers carried on business as hotel proprietors. Part of the hotel's business included owning and renting a two-storeyed building adjoining the hotel. Significant repair work was carried out after extensive damage was caused by fire on this building. The taxpayers claimed a deduction against their income for the portion of the repairs that insurance did not cover. Judge Barber disallowed the deduction on the basis that, due to the extent of the work undertaken, it was capital expenditure. See also Inland Revenue, ibid 71 [81]–[83].

<sup>75</sup> Ibid 70 [27], 100 [219].

<sup>76</sup> Ibid 104 [232].

strengthen the building.<sup>77</sup> As one would expect, based on *Colonial Motors (CA)*, Inland Revenue concludes that all the expenditure incurred is capital expenditure as it forms part of a single overall project to significantly change the character of the building.

In addition, there are three examples that may provide taxpayers with more general guidance in respect of earthquake-related expenditure on buildings. In Example 21,<sup>78</sup> concerning dilapidated assets, the taxpayers acquired a property at a discounted rate because of earthquake damage. The expenditure is on capital account on the basis that the costs relate to getting the property to a tenable state and therefore form part of the acquisition costs of that asset.

Example 22<sup>79</sup> relates to a commercial property that was damaged in an earthquake. Over time, and prior to the earthquake, the property had become dilapidated, so when the earthquake occurred the roof of the property was in a poor state and other repairs were required. Inland Revenue concludes that the expenditure undertaken by the owners is for accumulated repairs and revenue in nature. The work done brings the building back to the standard it was when the taxpayers acquired it.<sup>80</sup>

The third example, Example 23,<sup>81</sup> concerns a residential rental property that was significantly damaged in an earthquake. In order to bring the property back into a tenable state, the owners undertake extensive work including replacing the property's severely damaged foundations and rebuilding three of the property's collapsed external walls. On the basis of the extent of the work undertaken, Inland Revenue concludes the expenditure is on capital account as it 'results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset'.<sup>82</sup>

There are other examples in IS 12/03 which, while not specifically addressing earthquake-related work, may also provide some assistance to building owners undertaking work on their buildings.<sup>83</sup>

IS 12/03 acknowledges that 'where there is one overall capital project involving a group of assets, the nature of the expenditure on any repair work done on those assets is taken from the character of that one overall project, and the repair work is not looked at in isolation.'<sup>84</sup>

It is disappointing that the examples in IS 12/03, particularly, Example 17 (and also Example 23), add little to the decided cases, essentially describing extensive

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<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> Example 18 includes repair of an uneven floor due to subsidence: *ibid* 103 [232]. Example 14 considers major repairs to a leaky building, including removal and replacement of all external cladding and replacement of large sections of the building's timber framing: *ibid* 94 [175].

<sup>84</sup> *Ibid* 98 [200], 102 [232]. This view is based on a number of cases including *Colonial Motors (CA)*, *TRA Case X26*, and *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13 685.

undertakings where realistically there would be no issue as to the characterisation of the expenditures.<sup>85</sup> In its submission on what is now Example 17, NZICA argued for 'another example on earthquake strengthening where the work was not as extensive.'<sup>86</sup> Unfortunately for taxpayers, that call went unheeded.

The approach adopted by Inland Revenue of providing only one specific example of seismic strengthening (which closely follows existing case law), and ensuring other examples of earthquake-related building work are generally far from the capital-revenue boundary, may reflect the view that all seismic expenditure is capital and not deductible based on *TRA Case X26* and *Colonial Motors (CA)*. Alternatively, it may simply be an acknowledgement that the capital-revenue boundary in this context is unclear and, in Inland Revenue's view, further guidance is not possible at this stage.

## VII DISCUSSION: TO DEDUCT OR NOT TO DEDUCT, THAT IS THE QUESTION

### *A Introduction*

Determining whether expenditure is on capital or revenue account is essentially a factual enquiry. As such, there will always be scenarios coming before Inland Revenue, taxpayers (and their advisers), and ultimately the courts, with fine (and not so fine) factual differences from the decided authorities. As a consequence, it is not possible to state categorically in advance what the tax treatment of certain expenditure will be for a given specific scenario. However, irrespective of the type of expenditure, the aim should be to ensure that taxpayers, their advisers, and the revenue authority have clear guidelines and principles to work to in order for there to be as much certainty as possible.

Turning to the question of whether or not seismic strengthening costs can be deducted, on first blush, the likely answer to this question is 'no'. The two cases that have considered the seismic strengthening work have both concluded that such work is on capital account. A reading of IS 12/03, including the one specific example which is an application of *Colonial Motors (CA)*, reinforces this conclusion. In addition, if 'minor' strengthening work may in fact fall on the revenue side of the capital-revenue divide, *Colonial Motors (CA)* and *TRA Case X26* provide little, if any, assistance in discerning where such a divide exists. Unfortunately, the interpretation statement is also essentially silent on this issue.

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<sup>85</sup> It is interesting to observe that Inland Revenue, in both Examples 22 and 23, has modified the respective facts, compared with the equivalent examples in the exposure draft, to move the examples further from the capital-revenue divide, thereby reducing their utility. Thus, in Example 22, which illustrates repairs, the roof is now simply repaired rather than replaced (as in the exposure draft). Similarly, in Example 23, which illustrates reconstruction work, two collapsed external walls have now become three such walls, requiring rebuilding; in addition, now the floors of the rental property also require reconstruction.

<sup>86</sup> NZICA, *Income tax — Deductibility of Repairs and Maintenance expenditure — General principles*, 23 May 2012, 5. PWC describes many of the examples in the interpretation statement as 'either too extreme to be helpful or [they] do not contain sufficient information to support the Commissioner's view as to how the expenditure should be treated.': PWC, 'Repairs and maintenance – the Commissioner's view on the capital/revenue distinction' (2012) 4 *Tax Tips* 3.

Whether seismic strengthening costs are deductible depends on, first, identifying the relevant asset that is being repaired or worked on; and second, considering the nature and scale of the work undertaken to that asset, and whether, inter alia, the expenditure has changed the character of the asset. Where the seismic strengthening relates to a building, determining the asset will usually not be in dispute; the asset will be the building itself. The pessimism (at least from the taxpayer's perspective) expressed in the foregoing paragraph with respect to the deductibility of strengthening expenditure is essentially as a result of the application of the second step. As a general proposition, it is likely that due to the nature and extent of much strengthening work, the work will be on capital account, ie it will be reconstructive rather than remedial. This is the hurdle facing building owners. The expenditure will often result in a better asset than previously existed, normally a seismically strengthened building with an extended life expectancy (and potentially increased rental potential). By ensuring the continued availability of the asset as an income-producing structure, the work creates an advantage of a lasting character.

Against this somewhat negative background, the following paragraphs discuss the tax treatment of earthquake strengthening expenditure in different scenarios based on the existing case law and IS 12/03.

### ***B Strengthening an 'unsound' building***

The first scenario considers the income tax treatment of strengthening work undertaken on a building that is 'unsound'. In this case the subject building does not comply with the minimum Building Code standard and may, for example, not be safe to occupy or be under (possible) threat of closure or of being barricaded in the future. It is clear from the decisions in *Colonial Motors (CA)* and *TRA Case X26* that this expenditure will be on capital account. From a practical and business perspective, the work undertaken to make the building code compliant will transform it from an unsound (non-compliant) building with potentially a limited rental life into a compliant, sound building capable of being able to generate a future income stream. The expenditure creates an advantage of a lasting character and will prevent the potential sterilisation of the asset. It is likely that such work will result in a reconstruction, replacement, or renewal of substantially the whole of the asset.

The key to this determination is not that the building owner is compelled — perhaps on threat of a demolition order if work is not undertaken — to carry out the work. This is made clear in *TRA Case X26* where Judge Barber rejected the taxpayer's submission, based on the Canadian case of *Marklib Investments LL-A Ltd v R* (1999) 1 CTC 2 413,<sup>87</sup> that the need to comply with statutory or regulatory requirements in fact made the expense one of revenue. He observed that the issue of the income tax treatment of an expense 'is always the character of the particular expenditure.'<sup>88</sup> However, the

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<sup>87</sup> In this case, the taxpayers were required by the local municipal authorities to undertake substantial work otherwise they would be subject to penalties including fines and rent freezes. The expenditure was considered to be on revenue account.

<sup>88</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 323.



compulsion is an indicator both of the present (unsound) state of the building and the effect on the asset of any subsequent strengthening work.

Similarly, in *TRA Case X26* Judge Barber acknowledged that the possible barricading of the building in question had the work not been undertaken offered 'a *strong indicator* that the work was to protect a part of the income earning structure'.<sup>89</sup> This view is, however, not conclusive; indeed, he also observed that 'there could be a situation where a building was threatened with closure due to lack of repairs and maintenance. That threat would not convert the cost of remedial work into capital expenditure'.<sup>90</sup>

This discussion assumes that any such strengthening work undertaken on an 'unsound' building is by its very nature a major undertaking. In the unlikely event that only minor work is required to bring a non-compliant building up to code, in my view, such expenditure would be on capital account as it has still changed the building's character, transforming it from an unsound into a sound building.

### ***C Major strengthening of a 'sound' building***

A taxpayer may own a building which is sound, for example it currently complies with minimum Building Code standards and is not under threat of being barricaded. The continued occupation of the building is therefore not an issue. In this scenario, the owner may decide to strengthen the building (to a higher percentage of the building code) perhaps to attract or retain tenants. Alternatively, the owner may be required by its insurer to strengthen the building. The work undertaken by the owner may range from minor work to more extensive work.

The tax treatment of such strengthening work will again require a consideration of the nature and scale of the work undertaken. In *W Thomas & Co*, Windeyer J (cited in *Auckland Gas (PC)*) stated that a repair 'involves a restoration of a thing to the condition it formerly had *without* changing its character'.<sup>91</sup> Unlike the first scenario, above, in this case the character of the building is not transformed from an *unsound* to a *sound* building. However, where the work is extensive ('major') and results in a seismically strengthened building with an extended life expectancy (as well as potentially resulting in higher rentals and occupancy and reduced insurance premiums), the work will go beyond repairs and (minor) alterations, and will be on capital account. As a result of the expenditure, substantially the whole of the asset may have been reconstructed, renewed, or replaced.

This discussion raises an important issue. In the context of major seismic strengthening expenditure, a consideration of the nature and extent of seismic strengthening expenditure will include determining whether there has been the reconstruction, replacement, or renewal of *substantially the whole* of the asset. IS 12/03 provides no

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<sup>89</sup> Ibid 12 321 (emphasis added).

<sup>90</sup> Ibid 12 320.

<sup>91</sup> *W Thomas & Co* [1965] 115 CLR 58, 72 (emphasis added).

guidance on how the highlighted phrase is to be interpreted.<sup>92</sup> PWC suggests, based on a variety of authority, that the highlighted term means:

- not necessarily the whole, but as far as reasonably possible, the whole
- nearly all, only slightly less than all
- something less than a significant or substantial proportion
- all of the key components
- more than 75%.<sup>93</sup>

These suggested interpretations of the term ‘substantially the whole’ indicate that a high threshold is required before, in the case of a building for example, work undertaken will affect ‘substantially the whole of the asset.’ This high threshold may work in the taxpayer’s favour.

### ***D Minor strengthening of a ‘sound’ building***

#### *1 Introduction*

It is clear from the preceding analysis that much seismic strengthening work will not be deductible either because it transforms an ‘unsound’ building into a ‘sound’ building or because the extent of the work means substantially the whole of the asset has been reconstructed or renewed. This raises the question whether there may be arguments that smaller scale (‘minor’) strengthening work on a ‘sound’ building is deductible as repairs or minor alterations. After a general discussion of this issue in the following paragraphs, this section of the article considers specific factors which are indicators of the nature and extent of work undertaken on an asset and which may, depending on the specific facts, assist a taxpayer considering deducting seismic strengthening costs.

#### *2 General discussion*

In its submission on the exposure draft, NZICA gives the example of a building that requires strengthening to meet a change in the building code; however, the building is not ‘unsound’ and can be occupied. NZICA suggests: ‘Where there has been a change to building regulation such that some strengthening work is now required, we do not see this as necessarily being capital in nature if the work is minor only.’<sup>94</sup> The issue is what will constitute ‘minor’ work in this context? Would the addition of a steel beam ‘here or there’, the ‘odd column or two’, or a ‘bit of bracing’, be deductible repair work (assuming for example that the building remains the same size and layout)?

Neither *Colonial Motors (CA)* nor *TRA Case X26* consider this issue. In addition, due to the factual nature of the capital–revenue determination, care needs to be taken when arguing by analogy from other cases. The English case *Conn v Robins Bros Ltd* [1966] 43

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<sup>92</sup> With reference to the word ‘substantial’, Judge Barber observed that the relevant property had been substantially improved as it had gone ‘from less than 50% earthquake strength compliance to full compliance’: *TRA Case X26* (2006) 22 NZTC 12 315, 12 320.

<sup>93</sup> PWC, above n 86, 4.

<sup>94</sup> NZICA, above n 86, 5.

TC 266 (*Robins Bros*) is an example of the proposition that structural work can be deductible, albeit in *Robins Bros* the work undertaken was not necessarily of the nature and scale of that evident in the two cases considered in this article. In *Robins Bros*, extensive alterations were made to a building, parts of which were 200 and 400 years old, including replacing the slate roof with corrugated asbestos, removing walls, and inserting steel girders to the upper storeys. No additional space was created. Despite the substantial work undertaken on the building, the expenditure was on revenue account. In *Robins Bros* Buckley J stated:

unless something had been done, the state of the property would have become so decrepit that it would have been impossible for the company to continue to carry on its business there ... the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new [and on capital account].<sup>95</sup>

The taxpayers in *Colonial Motors (CA)* and *TRA Case X26* did not argue *Robins Bros* in support of their position, possibly on the basis that they believed the very unique facts in that case — a building which in part was 400 years old — distinguished it from the situations before them.<sup>96</sup> Inland Revenue in IS 12/03 also suggests that, on the basis of *Auckland Gas (PC)*:

if similar facts as in *Robins Bros* arose under the [*Income Tax Act 2007 (NZ)*], the expenditure would be found to be capital in nature on the basis that the character of the building had changed, or the work amounted to a reconstruction, replacement or renewal of substantially the whole of the asset, or both.<sup>97</sup>

*Sherlaw* may provide some support for building owners who, as a consequence of undertaking repair work, find seismic strengthening work is also required. In *Sherlaw*, the scheduled repair work had a flow-on effect of damaging the roof and floor of the boat shed, requiring their repair. What is interesting in this case is that overall the repairs were extensive, and critical to the boat-shed's continued use,<sup>98</sup> and yet the New Zealand High Court still held that the expenditure was deductible. Of crucial importance

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<sup>95</sup> *Robins Bros Ltd* [1966] 43 TC 266, 274.

<sup>96</sup> It is essentially this basis (that the Court took a long term view of maintaining/repairing a 400 year old building) that Inland Revenue suggests enables the case to be reconciled with *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102 ('*Western Suburbs*'), where the taxpayer unsuccessfully claimed a deduction for the replacement of a damaged ceiling with a new ceiling because it was impractical to repair: Inland Revenue, IS 12/03, above n 11, 87-88 [138]-[142]. The work undertaken in *Western Suburbs* was capital expenditure as the ceiling was replaced with one of more modern materials and had considerable advantages over the old ceiling: *ibid* 87 [138]. Inland Revenue observes that where, as in these two cases, major components of an asset are replaced rather than repaired, a judgement has to be made as to the nature of the work undertaken to the asset: *ibid* 88 [140]. According to Inland Revenue, the work undertaken in *Western Suburbs* improved the building while in *Robins Bros* the work was a natural part of the repair process and no improvement in the building was sought: *ibid* 88 [141]. In addition, in *Robins Bros* the 'building remained the same size and in the same location, and the court considered that the work did no more than maintain the building's inherent utility': *ibid*.

<sup>97</sup> *Ibid* 88 [142].

<sup>98</sup> Doogue J stated: 'I am satisfied beyond doubt that this work was entertained solely to ensure the survival of the boat-shed and its ability to be used by the taxpayer for the purposes for which he was then using it.': *Sherlaw* (1994) 16 NZTC 11 290, 11 291.

to the High Court's finding was the manner in which the work was undertaken. Inland Revenue observes:

[The case] highlights a situation where repairs are undertaken and those repairs have a flow-on effect, causing further repairs to be required. *The repairs when looked at as a totality might be extensive.* However, they were *not undertaken as a single overall plan* to improve the building or to replace or renew an asset.<sup>99</sup>

Had the work in *Sherlaw* instead been undertaken as part of one overall project, given the extensive nature of the work in combination, it seems likely that it might well have been on capital account. It may therefore be arguable that if additional, unscheduled 'minor' strengthening work is required on a sound building as a consequence of repair work, provided the building is not transformed, the entire expenditure may be deductible, even though had the work been undertaken as one pre-planned project it would have been on capital account.

A comment by the Privy Council (obiter) in *Auckland Gas* (PC) may also provide some limited support for the deduction of some earthquake strengthening work. Lord Nicholls commented with respect to the characterisation of work as repairs or replacement:

*Demolition and rebuilding of a dangerous flank wall of a house would normally be regarded as repairing the house.* The answer might not be so obvious if an entire derelict wing of a large house was demolished and rebuilt, especially if the new construction was substantially different from the original. Questions of degree may arise in such cases.<sup>100</sup> (Emphasis added.)

It is clear that if there is a programme to do seismic strengthening work on an asset, simply staggering or spreading the work over a number of years will have no impact of the characterisation of the expenditure. The taxpayer in *TRA Case X26* argued that she could have spread the work out over a period of years and charged it to repairs, but for the sake of the tenants in the buildings, she decided to complete the strengthening project as a whole. Judge Barber stated that he could only deal with facts as they were presented, but if the taxpayer had so proceeded, the character of the expenditure year by year would still have been of a capital nature. This approach is consistent with other cases, including *Auckland Gas* (PC), where Lord Nicholls in the Privy Council stated that the fact that the replacement work in that case was spread over a number of years did not change their Lordships finding (that the expenditure was of a capital nature).<sup>101</sup> Lord Nicholls also observed that 'the speed or slowness with which the work was carried out cannot affect its nature or, hence, its proper characterisation'.<sup>102</sup>

### 3 *The cost of the work undertaken*

The cost of the work done compared with the value of the asset can be an indicator of the nature and extent of the work undertaken. For example, if the cost of the work as a

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<sup>99</sup> Inland Revenue, IS 12/03, above n 11, 97 [192] (emphasis added).

<sup>100</sup> *Auckland Gas (PC)* (2000) 19 NZTC 15 702, 15 706.

<sup>101</sup> *Ibid* 15 708.

<sup>102</sup> *Ibid*.

percentage of the pre-improved value of the building is small, this may indicate the work undertaken is not major. The issue is what is 'small' relative to the value? In *TRA Case X26*, the total cost of the project was 9.9 per cent.<sup>103</sup> Judge Barber indicated that when the project's scope and expense were considered the expenditure was on capital account.<sup>104</sup> On a reading of the case it appears that the key determinant in this conclusion was the actual extent of the work undertaken and not the expense.

In my view, it is arguable that if the project work was less extensive, perhaps on the capital–revenue boundary, of itself this level of expense (as a percentage of the project) would not have made the expense on capital account. In fact, in a hypothetical example, PWC suggests that where work is undertaken on a house (to the walls, floor, and two external walls) costing NZ\$185 000 or 53 per cent of the value of the house, while the cost is significant, it 'doesn't suggest that substantially the whole house has been rebuilt.'<sup>105</sup> Indeed, in *Sherlaw* the cost of the repair work was NZ\$34 449, ie it exceeded the value of the property before the work was commenced (NZ\$22 000). However, this factor needs to be applied with caution: 'Sometimes the cost of repair work can be very high, for example, if the replacement parts are expensive or the repair work is difficult.'<sup>106</sup> As illustrated by the finding in *Auckland Gas*, where the cheaper replacement option was chosen, it may be more expensive to repair an asset than to replace it 'but the saving does not change the character of the work done from being capital.'<sup>107</sup>

#### 4 *Recurring expenditure?*

In *TRA Case X26* Judge Barber made it clear that the fact that, in the future, the regulatory authority might require further work to be undertaken on the building did not mean that the current work lacked an enduring benefit. Rather, when 'the words "permanent" or "enduring" are used in this connection it is not meant that the advantage which will be obtained will last forever: *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T* (1938) 61 CLR 337, at p 355 per Latham CJ.'<sup>108</sup> Judge Barber also stated: 'Earthquake strengthening is not necessarily an ongoing process as, hopefully, buildings are now built to more than comply with current standards of compliance.'<sup>109</sup>

In my view, Judge Barber downplayed the taxpayer's submission that earthquake strengthening may be an ongoing process (at least for older buildings) as building standards continue to be updated. Evidence was presented in the case that the WCC's

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<sup>103</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 320.

<sup>104</sup> *Ibid.*

<sup>105</sup> PWC, *Facts on Tax 2012 Suggested Solutions Winter Series* (2012), 56 (Question 15).

<sup>106</sup> Inland Revenue, IS 12/03, above n 11, 91 [172]. See *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15 001, 15 008 (*Poverty Bay Electric*).

<sup>107</sup> Inland Revenue, IS 12/03, above n 11, 91 [172]. In this case the option adopted by the taxpayer to repair the gas reticulation network — the insertion of polyethelene piping inside the existing cast iron and steel pipes — was chosen in part because it was less expensive than the alternative of repairing the leaking joints and replacing those parts that were corroded. The irony was that, had the taxpayer adopted the second but more expensive alternative, its costs would instead have been deductible as repairs — a point noted by the Privy Council: *Auckland Gas* (PC) (2000) 19 NZTC 15 702, 15 707.

<sup>108</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 324.

<sup>109</sup> *Ibid.*

standards for seismic strengthening had changed four times in a 14 year period.<sup>110</sup> It is reasonable to assume that the building code will be subject to greater scrutiny (and amendment) in the coming years as a result of various reviews by DBH, the Royal Commission and ongoing seismic research. This raises the question, 'if as a result of continual changes to the code, a building owner regularly undertakes 'minor' seismic strengthening work on their building, at what point could it be argued the work is regular and recurring (and deductible)?

PWC, with respect to a hypothetical example of the refurbishment of fuel pumps every 10 years, observes that: 'the degree of recurrence depends on the asset in question. When looking at whether the expenditure is recurrent the nature and life of the asset needs to be considered. In this case the pumps have a reasonably long life and the expenditure is recurrent, albeit at long intervals.'<sup>111</sup>

In *BP Australia*, the Privy Council considered what length of trade-tie agreement would point to recurrent revenue expenditure (on the basis at the end of the specific period BP Australia would renew the trade-tie). Their Lordships commented:

Had the agreements been only for two or three year periods that fact would have pointed to recurrent revenue expenditure. Had they been for 20 years, that fact would have pointed to a non-recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought.<sup>112</sup>

While the trade-tie periods varied between 3 and fifteen years, the predominant number of agreements was for a 5 year period. Their Lordships found this length of time 'to be neutral, and in itself indicates neither capital expenditure nor revenue by its mere length. It therefore does not add effectively to the argument either way.'<sup>113</sup> There may be a weak argument, based on *BP Australia*, that earthquake strengthening expenditure incurred regularly (less than 5 years) is deductible whereas expenditure incurred on a longer frequency is capital. I acknowledge that this is a very tentative proposition and, given the context of the statement in *BP Australia*, may not be applicable to such a different factual scenario. It also arguable, given the nature of this work, that strengthening is unlikely to occur at such frequent intervals.

## 5 *Duration of the undertaking and dislocation*

The taxpayer in *TRA Case X26* supported its contention that the work was not a major project by pointing to the fact that the work was only spread out over seven weeks to spread disruption to the tenants, the building remained operational during the work, and the rents continued to come in.<sup>114</sup> Judge Barber acknowledged these to be relevant

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<sup>110</sup> Ibid 12 325.

<sup>111</sup> PWC, above n 105, 54. It would appear in the PWC example the useful life of the particular fuel pumps is at least 30 years.

<sup>112</sup> *BP Australia* [1966] AC 224, 267.

<sup>113</sup> Ibid.

<sup>114</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 325.

factors;<sup>115</sup> however, in his view the overall nature and extent of the work before him outweighed these factors.

#### 6 *The impact on the capital value of the asset*

The effect of the work on the value of the property is another indicator of character of the expenditure. The evidence in *Colonial Motors (CA)* and *TRA Case X26* was that the work undertaken increased the value of the building — substantially in the former case. Judge Barber observed that there would be an immediate threat of loss of the income from the property, as an income-earning structure, if it were to be barricaded by the WCC, which could reduce the value of the property. It could therefore be argued that if seismic strengthening work has a negligible impact on the value of the building once the work is completed, this indicates the work undertaken is not reconstructive but remedial and deductible.

However, focussing on the post-improved value of a building is not necessarily a reliable indicator for the reason that repair work (as is also the case with reconstructive work) will often add value to the asset being repaired. It is to be expected that this will generally be the case even with 'minor' seismic strengthening work. Blanchard J in *Poverty Bay Electric* stated: 'It is worth observing that it is hard to see the adding of value as an essential element in capital expenditure when restoration or repair work usually adds value to the object which is restored or repaired.'<sup>116</sup> This position is supported by *TRA Case T43* (1998) 18 NZTC 8 287 which concerned repairs to a dilapidated wall, leaking roof, and rotten floorboards. The TRA concluded that the fact that the building may have a greater value as a result of the repairs did not convert the 'repairs' into an 'improvement'.

#### 7 *The useful life of the asset*

It may be that following seismic strengthening work (of a minor nature) the building's useful life is not extended, indicating that the expenditure is revenue in nature. However, again this may not be a reliable indicator. The Court of Appeal in *CIR v Auckland Gas Co Ltd* 19 NZTC 15 011, 15 024 observed that where the work done creates a new asset it is not essential that the life of the original asset be extended for the work undertaken to be capital in nature. Conversely, in that case, had the gas mains been repaired, the network's life would also have been extended, yet the work would still have been deductible.

#### 8 *The asset's functionality*

It is expected, unlike in *Colonial Motors (CA)* for example, that in many cases of seismic strengthening that the function of the building will remain the same, eg an office building will continue as such once strengthened. However, Lord Nicholls in *Auckland Gas (PC)* stated that a comparison of the functional position of an asset before and after

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<sup>115</sup> Ibid.

<sup>116</sup> *Poverty Bay Electric* (1999) 19 NZTC 15 001, 15 008.

work is done is not a reliable guide by itself as to whether the work undertaken is capital or revenue in nature.<sup>117</sup>

### 9 *The impact on the income earning capacity of the asset*

It could be argued that the fact that income earning capacity of the building remains the same after seismic strengthening work is undertaken demonstrates the building has not been improved. In *TRA Case X26*, the taxpayer argued that the expenditure did not increase the rentals the building was capable of generating (upon annual reviews), which showed that the expenditure did not improve the building. Judge Barber responded by observing that the expenditure was necessary to maintain the existing revenue stream and that, citing *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 (*Highland Railway*), 'an increase in revenue is not a necessary concurrent result of a capital expense which improves a capital asset'.<sup>118</sup>

While these factors discussed in this section may not be determinative, where the characterisation of minor expenditure to strengthen a building is finely balanced between capital or revenue expenditure, they may point to the work carried out on a building being repairs and therefore deductible.

### **E A recently acquired asset**

Where a taxpayer acquires a building that is in need of seismic strengthening — whether or not the building is 'sound' — based on existing case law,<sup>119</sup> it is likely that such subsequent strengthening expenditure will form part of the capital cost of acquiring the asset. However, there is an exception to this principle.<sup>120</sup> A deduction may be allowed for expenditure on repairs of a newly acquired asset if the purchase price of the asset was not affected by the state of disrepair and when the asset was acquired it could be used as intended despite its state of disrepair. It is unlikely this exception will apply to buildings requiring seismic strengthening, even if capable of continued occupation, as the purchase price will normally be reflective of the (possibly significant) work required.

### **F Mixed work and apportionment**

Inland Revenue's view, as outlined in section VI, is that repair work that is undertaken as part of a wider capital project will also be on capital account.<sup>121</sup> From a practical perspective, this interpretation is both disappointing for building owners and 'ignores

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<sup>117</sup> *Auckland Gas* (PC) (2000) 19 NZTC 15 702, 15 708.

<sup>118</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 323. In *Highland Railway* the taxpayer incurred the expense of replacing steel rails with iron ones without deriving any extra revenue as a result. The expenditure was considered on capital account because the asset had been materially altered and improved.

<sup>119</sup> *Law Shipping Co Ltd v IRC* [1924] 12 TC 621 and *W Thomas & Co* [1965] 115 CLR 58: Inland Revenue, IS 12/03, above n 11, 99–100 [212]–[218].

<sup>120</sup> *Odeon Theatres* [1972] All ER 681.

<sup>121</sup> Inland Revenue, IS 12/03, above n 11, 98 [200], 102 [232].



commercial reality',<sup>122</sup> as many building owners, faced with having to undertake strengthening work, will take the opportunity to carry out (unrelated) repairs and maintenance.

PWC appear to take a broader view on this matter<sup>123</sup> — and on the Inland Revenue's position — stating:

We submitted [in respect of the exposure draft] that, if the taxpayer can clearly separate the work undertaken as part of a single overall project into capital and revenue expenditure, they should be able to treat it according to its capital or revenue nature. We are pleased to see that Inland Revenue has amended the final statement to allow scope to do this.<sup>124</sup>

NZICA was also critical of the Inland Revenue position in the exposure draft — that repair costs within a capital project cannot be separated out — observing in its submission that in *Colonial Motors (CA)*, which is cited by Inland Revenue as authority for this proposition, part of the project expenditure was treated as on revenue account and deductible.<sup>125</sup> In its submission NZICA concludes, on the basis, inter alia, of *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61 271, that 'where a project is of an overall capital nature, it could still be possible to split out repair costs and treat them as deductible if there is sufficient evidence to do so.'<sup>126</sup>

An observation (obiter) by Judge Barber in *TRA Case X26* arguably also contradicts Inland Revenue's stated position on mixed work. In response to a submission by the taxpayer, Judge Barber acknowledged that had some of the alterations in that case been of a 'cosmetic' nature 'that amount [of expenditure] might be deductible as revenue depending on the precise character of that "cosmetic" alterations work'<sup>127</sup> (despite all being part of one project).<sup>128</sup>

In this respect, the position in Australia is also arguably more taxpayer friendly.<sup>129</sup> Australian Tax Office Taxation Ruling TR 97/23<sup>130</sup> permits taxpayers to distinguish and deduct genuine repairs even when they are undertaken as part of a larger capital project:

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<sup>122</sup> NZICA, above n 86, 7.

<sup>123</sup> PWC bases its view that repairs that are part of an capital project are deductible on statements such as Blanchard J in *Poverty Bay Electric* (1999) 19 NZTC 15 001, 15 008: 'an apportionment of an amount of expenditure is possible and appropriate — where a part of the money spent has been applied to work which is truly a repair and at the same time some upgrading of a capital nature has been done.': PWC, above n 105, 55. NZICA also cited this passage as support of this proposition: NZICA, above n 86, 6.

<sup>124</sup> PWC, above n 86, 3.

<sup>125</sup> NZICA, above n 86, 6. IS 12/03 considers this matter in more detail than the exposure draft, but the Inland Revenue view, as originally expressed in the exposure draft, remain. Inland Revenue, IS 12/03, above n 11, 98 [197]–[201].

<sup>126</sup> NZICA, above n 86, 7.

<sup>127</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 325.

<sup>128</sup> As no evidence was presented to the TRA on this point, Judge Barber reserved leave for the taxpayer to apply in that respect.

<sup>129</sup> Keating, above n 8, 314.

<sup>130</sup> Australian Tax Office, *Income Tax: Deductions for Repairs*, TR 97/23, 3 December 1997, 13–14 [55].

The character of a repair does not necessarily change because it is carried out at the same time as an improvement. If, for example, a shopping centre is extensively renovated or restored (the project combining repairs and improvements) and if some parts of the project can be effectively separated and considered in isolation from the rest of the project, they may still be repairs. It is necessary to examine separately the individual parts of the total project to determine whether any part, if considered in isolation, is a repair. It is not appropriate to have regard only to the result of the entire work done. It is inappropriate to regard the whole project as an affair of capital. In other words, if individual parts of the total project can be separated and characterised as repairs, and if their cost can be segregated and accurately quantified, their cost is deductible.<sup>131</sup>

However, TR 97/23 does qualify this statement, noting:

If however, repair work is inextricably bound up with work of an improvement nature, and the repair work cannot be separately segregated and its cost accurately quantified independently from the cost of the improvements, [the Australian Tax Office] regard the cost of the entire work as being of a capital nature.<sup>132</sup>

In my view this issue requires further judicial clarification in New Zealand.

The interpretation statement does accept that apportionment may be appropriate where 'it can be demonstrated that the [repair] work done is not part of that [overall] project'.<sup>133</sup> In the context of a capital project, this will mean that it is crucial that, where additional work of a repair nature is undertaken, the taxpayer can demonstrate 'from a practical and business point of view'<sup>134</sup> that the claimed repair work is *not* part of the overall project to change the character of the property.<sup>135</sup> In its submission on the exposure draft, NZICA stated that it believed 'taxpayers ... need specific guidance as to what would constitute a "project"'.<sup>136</sup> They questioned whether the test would be one of timing: 'If repair work is done at the same time as capital work, would this be sufficient to make it capital in nature?'<sup>137</sup> Would the answer be different if the repair work was carried out 'soon after' the capital work.<sup>138</sup> NZICA's submission also noted that in *Colonial Motors* (CA), Inland Revenue accepted repair work as deductible where estimates for the work, and subsequent dockets and invoices, were separated into three categories (including repairs and maintenance).<sup>139</sup> NZICA added:

If two different streams of work are carried out at the same time, using different project managers and different contractors, we assume that this would constitute two separate "projects". However, what would be the situation were there merely two different cost

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<sup>131</sup> Ibid.

<sup>132</sup> Ibid 14 [56].

<sup>133</sup> Inland Revenue, IS 12/03, above n 11, 98 [205].

<sup>134</sup> Ibid 99 [206].

<sup>135</sup> See Example 20, *ibid* 104 [232].

<sup>136</sup> NZICA, above n 86, 7.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> Ibid.

centres? The two workstreams accounted for separately? Two different quotes for the work?<sup>140</sup>

Taxpayers will need to take clear, practical steps to ensure any repair work undertaken on a building at the same time as capital work is treated as a separate project. This would best be demonstrated by the taxpayer using different project managers and different contractors. However, for a number of reasons this may not be possible. Determining whether there is more than one single overall project and, in the event that the answer is in the affirmative, how the expenditure is to be apportioned between projects, has the potential to be a fertile ground for dispute between Inland Revenue and taxpayers.

Finally, based on *Sherlaw*, apportionment of expenditure between capital and revenue will be appropriate where the primary work undertaken is a repair, but at the same time some upgrading of a capital nature occurs.<sup>141</sup>

### VIII CONCLUSION

Discerning the capital–revenue boundary can be difficult, hence the large volume of case law. However, there is little judicial guidance on the tax treatment of strengthening work undertaken on a building. The two cases discussed in this article conclude that at least significant strengthening work undertaken on a building is on capital account. However, the cases present difficulties in terms of precedent, *TRA Case X26* because, as a decision of the TRA in its (former) small claims jurisdiction, it is in fact non-precedential, although the reality is that it will be used as some form of ‘authority’ given the limited case law on the topic. *Colonial Motors (CA)*, on the other hand, as a decision of the Court of Appeal, is significant. However, again its precedential value is ‘muddled’ as the seismic work was part of a wider project and was considered accordingly. Further, the Court did not conclusively determine whether the strengthening work was ‘alterations’ or went beyond that, preferring to conclude based on the now repealed *Income Tax Act 1976* (NZ) s 108 (ie the work undertaken had increased the capital value of the building by more than was expended.)

The greatest hurdle taxpayers have to overcome to successfully claim a deduction for seismic strengthening is that the effect of such work from a business and practical perspective is to significantly strengthen a capital asset and by its very nature the work will normally provide an enduring benefit and positively impact the taxpayer’s business structure. Where minor strengthening work is undertaken on a sound building there may be arguments that such work is on revenue account. Likewise, where work on a building is comprised of more than one project, the repair component may be deductible. However, based on the case law, including *Hallstroms*, and the nature of the work, it is likely the majority of all such strengthening work will be capital expenditure. Support for this view can be drawn from a consideration of the potential consequences if no action is undertaken. In such a scenario, the landlord could find retaining and

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<sup>140</sup> Ibid 8. See generally Stephen Tomlinson and Frank Burgess, ‘Repairs and Maintenance’ (Paper presented at NZICA Annual Tax Conference, Auckland, 26–27 October 2012) 16.

<sup>141</sup> Inland Revenue, IS 12/03, above n 11, 99 [206].

attracting tenants difficult and also face issues with obtaining ongoing insurance cover.<sup>142</sup> Ultimately, the owner could be subject to threats of building closure or demolition by the local council, ie the sterilisation of the asset.

To the extent that seismic strengthening costs are therefore not deductible because they are capital expenditure, such expenditure, which previously would have been depreciated along with the building, will now not be depreciable. This will place even greater pressure on the boundary between repairs and capital improvements and may see taxpayers test it in the future. Keating's observations with respect to the nil building depreciation rate are similarly applicable to the tax treatment of seismic strengthening expenditure: 'Taxpayers are incentivised to adopt aggressive or questionable interpretations in an attempt to have the expenditure recharacterised as another class of deductible or depreciable expenditure.'<sup>143</sup>

Due to the large number of buildings in New Zealand which will require seismic strengthening in the future, in my view, there is an argument to incentivise (or at least support) building owners through the tax system to undertake what may be very expensive work. This could be achieved either by legislating a specific deduction for earthquake strengthening costs or permitting the depreciation of such costs. The latter is more feasible in terms of its impact on the fiscal purse, and more realistic as it recognises the on-going benefit from the work undertaken on the building. It is acknowledged that there may be boundary issues where seismic strengthening and other unrelated structural work may be undertaken on a building; however, such issues arguably could be determined by reference to the structural engineers report or relevant council documents. Other options to assist building owners could include central or local government grants or low or interest-free loans to assist with the expenditure incurred. A future study could consider these and other options.

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<sup>142</sup> Williams comments that unreinforced masonry buildings may become uninsurable without strengthening work: David Williams, 'Insurance hurdle for old buildings', *Fairfax NZ News* (online), 2 March 2012, <<http://www.stuff.co.nz/businesses/6509555/insurance-hurdle-for-old-buildings>>.

<sup>143</sup> Keating, above n 8, 311.

**USING ON-LINE ASSESSMENTS IN A DISTANCE LEARNING TAXATION COURSE:  
EFFECTS ON STUDENTS' PERFORMANCE**

LIN MEI TAN\*

**ABSTRACT**

This study examines students' use of on-line assessments (formative), and on-line multiple choice question (MCQ) tests (summative) on students' performance in the final examination in a taxation course. The results show that the majority attempted the on-line MCQ test on time, but only used the on-line assessment resources when it was near the examination time. However, both their on-line MCQ test score and on-line assessment attempts had no significant impact on performance in the final examination. Instead, GPA stood out as the most important predictor of exam score, followed by tax assignment score and prior tax knowledge.

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## I INTRODUCTION

Taxation is a complex subject as not only is the body of tax law voluminous, overwhelming, and constantly changing, but there are also countless exceptions to many provisions in the statutes.<sup>1</sup> Therefore, taxation is a subject that challenges not only students attempting to develop a good understanding of the law but also educators who teach tax courses.

Teaching is about enabling learning<sup>2</sup> and teachers have to consider various learning pedagogies to engage or promote student learning. With the advent of computers, interactive learning through the use of on-line self-assessment questions<sup>3</sup> has been widely used by teachers in numerous disciplines such as economics, finance, and accounting.<sup>4</sup> Amongst other types of on-line assessment approaches (eg true/false, fill-in-the-blanks, and short answers), the multiple choice ('MC') question format is one of the most commonly used for students to self-assess their mastery of the subject matter and for educators to evaluate students' understanding of the topics covered.<sup>5</sup> The multiple choice format is a popular formative and summative assessment tool as it can cover a wide range of topics, and saves a tremendous amount of teacher's grading time. Although the use of MC assessments was originally driven by a growing number of students and reduced teaching resources,<sup>6</sup> it has become even more popular with advanced technology because grading of MC questions, and feedback to students, can be instantaneous. However, since MC questions require the selection of a correct answer from a set of alternatives, ie the recognition of the answer rather than the construction of a response, many have questioned its adequacy for assessing students because it fails to test analytical and communication skills adequately.<sup>7</sup> Instead, constructed response ('CR') questions (eg written essays or reports, etc) are considered more appropriate because a higher level of cognitive understanding is examined in comparison to MC questions.<sup>8</sup>

Empirical evidence from some researchers suggests that MC questions are effective tools for learning and are as good a measure of students' understanding as CR questions.<sup>9</sup>

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<sup>1</sup> Cynthia Bolt, 'Case Studies for Introductory Tax: Integrating Research and Ethics' (2006) 11 *Research on Professional Responsibility and Ethics in Accounting* 207.

<sup>2</sup> Jerome Feldman and Doug McPhee, *The Science of Learning and the Art of Teaching* (Thomson Delmar Learning, 2008).

<sup>3</sup> Also commonly referred to as computer based assessments.

<sup>4</sup> Stephen Buckles and John Siegfried, 'Using Multiple-Choice Questions to Evaluate In-Depth Learning of Economics' (2006) 37 *Journal of Economic Education* 48.

<sup>5</sup> Lynn Bible, Mark Simkin, and William Kuechler, 'Using Multiple-Choice Tests to Evaluate Students' Understanding of Accounting' (2008) 17 *Accounting Education* 555.

<sup>6</sup> Pru Marriot and Alice Lau, 'The Use of On-line Summative Assessment in an Undergraduate Financial Accounting Course' (2008) 26 *Journal of Accounting Education* 73.

<sup>7</sup> David Nicol, 'E-Assessment by Design: Using Multiple-Choice Tests to Good Effect' (2007) 31 *Journal of Further Higher Education* 53.

<sup>8</sup> Above n 5.

<sup>9</sup> See, eg, Lynn Bible et al, above n 5; Tom Buchanan, 'The Efficacy of a World-Wide Web Mediated Formative Assessment', (2000) 16 *Journal of Computed Assisted Learning* 193; and Howard Wainer and

*Footnote continues over page*

Buchanan,<sup>10</sup> for instance, found that the level of use of on-line MC questions correlates positively with examination performance in psychology. Bible et al<sup>11</sup> showed that accounting students' test scores on MC questions correlate positively with scores on CR questions. However, they noted the difficulty of simple extrapolation of research results in one area of study to other areas due to differences in abilities and the cognitive skills required in different contexts. One specific area they aptly pointed out is that the study of taxation, which concentrates on tax law, may require a different set of skills or knowledge than other studies. A study in tax, they suggested, would not only offer some additional insight into the MC/CR questions debate but also strengthen the application of results across other accounting fields. Other researchers<sup>12</sup> also called for more research on the effectiveness of on-line or MC assessment on student learning in various disciplines.

This study extends previous research by focusing on students' use of on-line and MC assessments provided in a taxation course and their relationship with students' performance in the final examination. Contrary to some prior findings, the results showed that both the on-line multiple choice question ('MCQ') test score and on-line assessments attempts had no significant impact on students' performance in the final examination. Instead, GPA stood out as the most important predictor of exam score, followed by tax assignment score and prior tax knowledge.

The next section reviews the literature on formative and summative assessments and the use of MC questions or CR questions. Section 3 describes the research method adopted for the study. The empirical results are reported in Section 4 and the last section provides the conclusion.

## II LITERATURE REVIEW

Assessments can be summative or formative, on-line or offline (paper based), compulsory or voluntary, and supervised or unsupervised.<sup>13</sup> Summative assessment (compulsory) is different from formative assessment as it involves a formal testing of what students have learned to produce a mark or grade. Formative assessment (voluntary) on the other hand is set out to give students feedback on their performance and/or the skills gained in performing the task.<sup>14</sup> Usually no course grades are awarded

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David Thissen, 'Combining Multiple-Choice and Constructed-Response Test Scores: Toward a Marxist Theory of Test Construction' (1993) 6 *Applied Measurement in Education* 103.

<sup>10</sup> Above n 9.

<sup>11</sup> Above n 5.

<sup>12</sup> See, eg, Sally Aisbitt and Alan Sangster, 'Using Internet-based On-line Assessment: A Case Study' (2005) 14 *Accounting Education (Int)* 383; William Kuechler and Mark Simkin, 'Why is Performance on Multiple-choice Tests and Constructed-Response Tests Not More Closely Related? Theory and an Empirical Test' (2010) 8 *Decision Sciences Journal of Innovative Education* 55; Daniel Murphy and Keith Stanga, 'The Effects of Frequent Testing in an Income Tax Course: An Experiment' (1994) 12 *Journal of Accounting Education* 27; and Stephanie Watson, Barbara Apostolou, John Hassell and Sally Webber, 'Accounting Education Literature Review (2003–2005)' (2003) 25 *Journal of Accounting Education* 1.

<sup>13</sup> Mary Peat and Sue Franklin, 'Has Student Learning Been Improved by the Use of Online and Offline Formative Assessment Opportunities?' (2003) 19 *Australian Journal of Educational Technology* 87.

<sup>14</sup> Mike Thelwall, 'Computer-Based Assessment: A Versatile Educational Tool' (2000) 34 *Computers and Education* 37.

for this type of assessment and it can be done in class time (supervised) or the students' own time (unsupervised). Quick feedback is desirable for formative assessment as it is a more effective way of improving and accelerating student's learning than when delivered after a lapse of time, such as when marking is done manually.<sup>15</sup> Various types of self-tests, such as the use of MC questions, quizzes, true/false questions are therefore considered good tools to use to empower students as self-regulated learners.<sup>16</sup> MC questions, for instance, if administered in an open book situation, allow students to self-assess and self-correct during a testing session.<sup>17</sup> With students nowadays having access to computers, and most universities adopting Learning Management Systems (eg Moodle, WebCT, Blackboard etc), computerisation of such assessment allows instant marking and feedback. This further enhances students' ability to self-regulate their own learning; they can decide when and how many times they like to attempt the questions. Feedback from students about on-line formative assessments is generally positive.<sup>18</sup>

Although MC testing is widely used in tertiary education across various disciplines, educators' reactions to the use of this instrument are mixed. Some educators believed that MC tests are only good for assessing students' ability to memorise and are not useful for assessing high order cognitive skills such as understanding, application, analysis and evaluation.<sup>19</sup> Those who dispute the use of MC questions argue that CR questions provide a better measure of a student's ability to solve real world problems. With essays, for instance, educators can better evaluate how well their students are able to communicate their reasoning.<sup>20</sup> Essays can test complex thinking by requiring students to organise, integrate, and interpret information, construct arguments, and give explanations.<sup>21</sup> Other researchers,<sup>22</sup> however, maintain that this depends on how the tests are constructed. Carnerson, Delpierre, and Masters<sup>23</sup> argue that MC questions do

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<sup>15</sup> John Dempsey, Marcy Driscoll, and Linda Swindell, 'Text-based feedback' in John Dempsey and Gregory Sales (eds), *Interactive Instruction and Feedback* (Educational Technology Publications, 1993) 21.

<sup>16</sup> David Nicol and Debra Macfarlane-Dick, 'Formative Assessment and Self-Regulated Learning: A Model and Seven Principles of Good Feedback Practice' (2006) 31 *Studies in Higher Education* 99.

<sup>17</sup> Above n 7.

<sup>18</sup> See Pru Marriot and Alice Lau, above n 6, and Dan Scheiwe and Renee Radich, 'A Programme to Address Emerging Problems in Auditing Education in Australian Universities' (1997) 6 *Accounting Education* 25.

<sup>19</sup> See Peter Airasian and Michael Russell, *Classroom Assessment: Concepts and Applications* (McGraw-Hill Education, 2008); Lorin Anderson and David Krathwohl (eds), *A Taxonomy for Learning, Teaching and Assessing: A Revision of Bloom's Taxonomy of Educational Objectives* (Longman, 2001); and Karen Scouller, 'The Influence of Assessment Method on Students' Learning Approaches: Multiple Choice Question Examination Versus Assignment Essay' (1998) 35 *Higher Education* 453.

<sup>20</sup> See Gregory Hancock, 'Cognitive Complexity and the Comparability of Multiple-Choice and Constructed-Response Test Formats' (1994) 62 *Journal of Experimental Education* 143 and Todd Rogers and Dwight Harley, 'An Empirical Comparison of Three- and Four-Choice Items and Tests: Susceptibility to Test Wiseness and Internal Consistency Reliability' (1999) 59 *Educational and Psychological Measurement* 234.

<sup>21</sup> See, eg, James McMillan, 'Fundamental Assessment Principles for Teachers and School Administrators' (2000) 7 *Practical Assessment, Research and Evaluation*, <<http://PAREonline.net/getvn.asp?v=7&n=8>>; Robert Thorndike, *Measurement and Evaluation in Psychology and Education (6th Edition)* (Merrill, 1997); and Blaine Worthen, Walter Borg, and Karl White, *Measurement and Evaluation in the Schools* (Longman, 1993).

<sup>22</sup> Alex Johnstone and Abdullah Ambusaidi, 'Fixed Response: What Are We Testing?' (2000) 1 *Chemistry Education Research and Practice (Europe)* 323.

<sup>23</sup> John Carnerson, Georges Delpierre and Ken Masters, 'Designing and managing MCQ' (1998), <<http://web.uct.ac.za/projects/cbe/mcqman/mcqcont.html>>.



not have to test merely facts; they can require interpretation and probe understanding. In addition, CR questions do not provide a good sampling of content knowledge across a curriculum, and marking is more time consuming and less objective, particularly if several markers are involved.<sup>24</sup>

Underlying the arguments for and against the use of MC testing is the question of what exactly students should learn from the course. According to Bloom's<sup>25</sup> taxonomy of educational objectives, different levels of learning can be classified in the following order (from lowest to highest): knowledge (that can be recalled), comprehension (ability to interpret and make comparisons), application (ability to rephrase knowledge or apply it to new circumstances), analysis (ability to break a problem into its constituent parts and establish the relationships between each one), synthesis (ability to put together pieces of information), and evaluation (ability to make judgment of the worth of something).<sup>26</sup> Bloom's taxonomy suggests that mastery of the lower learning objectives allows the learner to progress onto the higher learning objectives involving analysis, synthesis, and evaluation. MC questions therefore can be used in many different subject areas, as they can be set to measure a great variety of cognitive educational objectives.<sup>27</sup> They are adaptable to various levels of learning outcomes, from simple recall of knowledge to more complex levels, such as the student's ability to analyse phenomena, apply principles to new situations, comprehend concepts and principles, discriminate between fact and opinion, interpret cause-and-effect relationships, judge the relevance of information, and make inferences from given data and solve problems.<sup>28</sup> Since the student selects a response from a list of alternatives rather than supplying or constructing a response, multiple-choice test items, however, are not adaptable to measuring certain learning outcomes, such as the student's ability to articulate explanations, display thought processes, furnish information, organise personal thoughts, perform a specific task, produce original ideas or provide examples. Such learning outcomes are better measured by using CR questions.<sup>29</sup>

Empirical evidence on the relationship between MC assessment and students' performance contains mixed results.<sup>30</sup> Buchanan<sup>31</sup> and Lowry<sup>32</sup> found that students who attempted the MC questions (formative assessment) performed better in the final examination than those who did not. Further support for MC assessment can be found in

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<sup>24</sup> See McMillan, above n 21.

<sup>25</sup> Benjamin Bloom, *Taxonomy of Educational Objectives: The Classification of Educational Goals* (Longman Group, 1956).

<sup>26</sup> See George Brown, Joanna Bull and Malcolm Pendlebury, *Assessing Student Learning in Higher Education* (Routledge, 1997) and Hamish Anderson, 'Formative Assessment: Evaluating the Effectiveness of On-line Quizzes in a Core Business Finance Course' (2009) 13 *The Journal of Distance Learning* 26.

<sup>27</sup> Bill Jarnagin and John Harris, 'Teaching with Multiple Choice Questions' (1977) L11 *The Accounting Review* 930.

<sup>28</sup> *Ibid.*

<sup>29</sup> Above n 26.

<sup>30</sup> Above n 6.

<sup>31</sup> Above n 9.

<sup>32</sup> Roy Lowry, 'Computer Aided Self Assessment — An Effective Tool' (2005) 6 *Chemistry Education Research and Practice* 198.

a study by Potter and Johnston.<sup>33</sup> Their findings indicate that the use of a virtual learning environment, (which also used MC questions apart from other features), and prior knowledge, had a significant positive impact on performance whereas other factors like gender or student status (domestic or international) did not. Gretes and Green's<sup>34</sup> study showed that education students who took computerised practice exams averaged better scores than those who did not. In contrast, prior academic achievement (using a Scholastic Aptitude Test as a measure) and the amount of practice had no relationship with achievement score. Other studies have provided evidence that MC testing and CR testing do in fact measure the same thing,<sup>35</sup> and that formative computer based assessments can aid retention of concepts<sup>36</sup> and subject mastery.<sup>37</sup>

On the other hand, Becker and Johnston<sup>38</sup> found no relationship between performance on MC and essay questions in economics examinations because they measure different dimensions of understanding. The study by Peat and Franklin<sup>39</sup> also indicated that although the majority of students use both offline and on-line assessment resources and find them useful, their use has no differential impact on final learning outcomes. Sangster<sup>40</sup> also found no significant correlation between MC testing performance and marks achieved in the examination essays. These findings suggest that perhaps the mixed results in the extant literature are due to differences in disciplines which may have specific learning outcomes, or that the CR examination and the MC questions measure different dimensions of understanding. It is also possible, as pointed out by Sangster,<sup>41</sup> that student's learning style may have a role to play in predicting student performance.

Taxation is a highly specialised field and students who are enrolled in such a course are required not only to gain the technical knowledge but also to learn analytical, problem solving, critical thinking, and communication skills. Students need to be able to identify the tax issues or tax problems in simple and complex tax situations, and know the tax implications of various transactions. The use of MC testing is less extensive in comparison to other subject areas as it is more difficult to set due to the many exceptions and ambiguities in tax law. Interestingly, research into the effectiveness of

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<sup>33</sup> Bradley Potter and Carol Johnston, 'The Effect of Interactive On-Line Learning Systems on Student Learning Outcomes in Accounting' (2006) 24 *Journal of Accounting Education* 16.

<sup>34</sup> John Gretes and Michael Green, 'Improving Undergraduate Learning with Computer Assisted Assessment' (2000) 33 *Journal of Research in Computers in Education* 46.

<sup>35</sup> See, eg, Randy Bennett, Donald Rock and Minhwei Wang, 'Equivalence of Free-response and Multiple-choice Items' (1991) 28 *Journal of Educational Measurement* 77; Bible et al, above n 5; Bromley Kniveton, 'A Correlational Analysis of MC and Essay Assessment Measures' (1996) 56 *Research in Education* 73; and Wainer and Thissen, above n 9.

<sup>36</sup> Paul Bocij and Andrew Greasley, 'Can Computer-based Testing Achieve Quality and Efficiency in Assessment?' (1999) 1 *International Journal of Education and Technology* 1.

<sup>37</sup> John Whiting, 'The Use of a Computer Tutorial as a Replacement for Human Tuition in a Mastery Learning Strategy' (1985) 9 *Computers in Education* 101.

<sup>38</sup> William Becker and Carol Johnston, 'The Relationship Between Multiple Choice and Essay Response Questions in Assessing Economics Understanding' (1999) 75 *Economic Record* 348.

<sup>39</sup> Above n 13.

<sup>40</sup> Alan Sangster, 'Objective Tests, Learning to Learn and Learning Styles' (1996) 5 *Accounting Education* 131.

<sup>41</sup> *Ibid.*

MC questions in taxation is scarce and very few studies that have examined on-line assessments in taxation are published. Murphy and Stanga<sup>42</sup> provided some empirical evidence from an introductory income tax course of the effects of exam frequency on student learning throughout a course, the retention of material covered, and student evaluation of the learning process. Their results suggest that although frequent exams (which consisted of both MC questions and problems) increase student learning throughout the term and lead to more favourable evaluations of the instructor, they did not improve student retention of the material covered. As not many research studies have focused on taxation, this study extends prior research on the use of on-line assessments including MC testing in both formative and summative assessments by examining their relationship with students' performance in a taxation course.

### III RESEARCH METHOD

#### *A Sample*

A study was conducted on students enrolled in the Estate and Tax Planning course in 2010 in a multi-campus university in New Zealand. There were 124 students enrolled in the course. Four students withdrew from the course a few weeks after it commenced and seven students did not sit the final examination. Thus, a total of 113 students were graded in the final exam.

#### *B Course description and assessments*

The Estate and Tax Planning course is a distance learning course which caters primarily to those who are enrolled in the Graduate Diploma in Business Studies. Students are not required to have completed any taxation course before they enrol in this course. However, other Business Studies students who have an interest in this course are also allowed to enrol. The Estate and Tax Planning course is comprised of two parts and runs for 12 weeks. Part 1 is focused on various laws that are relevant to estate planning (eg *Wills Act 2007*, *Property (Relationships) Act 1976*, *Family Protection Act 1955*, etc), and requires students to complete one written assignment (CR questions) and answer two questions (CR questions)<sup>43</sup> in the final exam. Part 2 is focused on taxation and requires the completion of one written assignment (CR question), an on-line test which is exclusively multiple choice (20 questions),<sup>44</sup> and answering three questions (CR questions) in the final exam.<sup>45</sup> The two parts are each taught by two different staff members, who also grade the assessments for their respective parts.<sup>46</sup>

The course requires an average of 12.5 hours of study each week and students have the option of attending a one-day on-campus course. Study materials including review

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<sup>42</sup> Above n 12.

<sup>43</sup> The two questions in the final exam carry 40% of the total exam marks.

<sup>44</sup> Students were asked to select the best answer from the four choices given.

<sup>45</sup> The three questions in the final exam carry 60% of the total exam marks. The exam questions require students to provide justifications for their answers to questions posed on several different tax scenarios.

<sup>46</sup> The author of this paper coordinates the taxation part of the course.

questions and answers are provided to students once they have enrolled in the course. On-line formative assessments and summative assessments (ie quizzes which include MCQs) were used for the first time in the tax component in 2010.

This study focused on Part 2 of the course, ie the taxation component. In the past, the course was only web supported with very little incorporation of on-line learning. In 2010, with Stream (a version of Moodle)<sup>47</sup> providing e-Learning resources on-line, voluntary interactive quizzes on various taxation topics were introduced by the author to engage students in the learning process.

It is hoped that the different levels of interactive tutorials will help to bring students of various backgrounds up to speed with their learning of the current tax law, and also flesh out the fundamentals of various topics covered. In addition, computer-marked quizzes, as pointed out in the literature,<sup>48</sup> offer several other advantages, such as students' ability to self-assess and check their progress in a topic through feedback and identify areas of misunderstanding. All 113 interactive questions,<sup>49</sup> covering various topics before the tax assignment was due, were made available to students on-line and it was left to students to decide whether they wanted to self-assess their understanding of the topic before they embarked on the assignment. The quizzes were in the form of MC (n=32), True/False (n=54), and Yes/No (n=27) type questions. There was no limit to the number of times students could choose to attempt a quiz. A score and feedback was provided to students once they submitted their answers to each set of questions. At the end of the course, the students were asked to share their impressions and comments about the interactive quizzes and the multiple choice on-line summative assessment, which was used for the first time in this course.

A family tax scenario was provided in the tax assignment and students were required to write a report on the tax implications of transfers of various types of assets to different parties, investments choice, dividend and fringe benefit tax implications, and business structure implications. The assignment carried 15% towards the total course grade.

Students were required to complete the on-line MC test in the last week of the semester. It was open book and as most students were working full time, they were given a week to complete the test. This quiz contributed only 5% towards the total course grade. The test covers the topics that were not included in the tax assignment.

### **C Model**

Many of the prior studies described in the literature review studied the influence of personal and contextual factors on students' performance in isolation from other factors.<sup>50</sup> In some cases, only bivariate correlations were used to examine the

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<sup>47</sup> See *About Moodle* <<https://moodle.org/about/>>.

<sup>48</sup> Above n 5.

<sup>49</sup> Forty-one questions were provided in week 6, 41 questions in week 7, and 28 questions in week 8. Assignment 2 (tax component) was due in Week 9.

<sup>50</sup> Jan Vermunt, 'Relations Between Student Learning Patterns and Personal and Contextual Factors and Academic Performance' (2005) 49 *Higher Education* 205.

relationships, without considering the possible influence of other personal or contextual factors such as age or prior educational background. Such analysis does not tell us which factors are useful predictors of students' performance in the exam. This study used a multiple regression model to predict which of the independent variables were useful predictors of performance in the final exam. The dependent variable was students' score in the tax component in the final exam. The exam had no MC questions and only CR questions were used. One question required students to apply their tax knowledge to a case study of an investor, indicating the tax implications of the various income and expenses derived or incurred by the investor. The remaining questions provided various tax scenarios with a number of true/false statements and students were required to indicate whether the statement was true/false by providing justifications.

The independent variables were students' scores in the MC test and the tax assignment, attempted on-line quizzes, prior tax knowledge, GPA score, gender and age. As students might not have attempted all the interactive quizzes, it was assumed that students who completed at least two thirds of the total quizzes would have self-assessed a substantial portion of the examinable topics and the feedback might have enhanced their learning of those topics. Entwistle<sup>51</sup> identified some student characteristics as factors that may affect the way students go about learning and studying. Among them are prior knowledge, intellectual ability, and motivation. In this study, prior tax knowledge was included as an independent variable as some students might have completed an introductory tax course before. Previous studies have shown that prior knowledge has an impact on students' performance.<sup>52</sup> Students' abilities have also been shown, in numerous studies,<sup>53</sup> to be correlated with academic achievement or aptitude. In this study, ability was measured by using the students' most recent grade point averages ('GPA').

Age may be another influencing variable as there could be differences between younger and more mature students in their learning; the latter may bring more life experiences to a learning situation. Studies which examine gender produced mixed results with some<sup>54</sup> suggesting that males perform better on MC tests than female students, and others finding no significant gender differences.<sup>55</sup> Vermunt<sup>56</sup> further found no

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<sup>51</sup>Noel Entwistle, 'Approaches to Studying and Levels of Understanding: The Influences of Teaching and Assessment' in John Smart (ed), *Higher Education: Handbook of Theory and Research* (Agathon Press, 2000) 156.

<sup>52</sup> See, eg, Lin Mei Tan and Fawzi Laswad, 'Impact of prior content and meta-cognitive knowledge on students' performance in an introductory accounting course' (2008) 20 *Pacific Accounting Review* 63.

<sup>53</sup> See, eg, Robert Brookshire and Susan Palocsay, 'Factors Contributing to the Success of Undergraduate Business Students in Management Science Courses' (2005) 3 *Decision Sciences Journal of Innovative Education* 99 and Burch Kealey, Jonna Holland, and Marsha Watson, 'Preliminary Evidence on the Association Between Critical Thinking and Performance in Principles of Accounting' (2005) 20 *Issues in Accounting Education* 33.

<sup>54</sup> See, eg, Bible et al, above n 2; Brent Bridgeman and Charles Lewis, 'The Relationship of Essay and Multiple-choice Scores with Grades in College Courses' (1994) 31 *Journal of Educational Measurement* 37; and William Kuechler and Mark Simkin, 'How Well do Multiple Choice Tests Evaluate Student Understanding in Computer Programming Class?' (2003) 14 *Journal of Information Systems Education* 389.

<sup>55</sup> Nixon Chan and Peter Kennedy, 'Are Multiple-choice Exams Easier for Economics Students? A Comparison of Multiple-choice and "Equivalent" Constructed-response Exam Questions' (2002) 68 *Southern Economic Journal* 957.

differences between male and female students in their approach to learning. Because of the possible association between these demographic factors, age and gender of students were used as control variables in this study.

In summary, the multiple regression model used to test students' performance was:

$$\text{Taxexam} = \text{Intercept} + \beta_1 \text{Gender} + \beta_2 \text{Age} + \beta_3 \text{Taxknow} + \beta_4 \text{Onlinequiz} + \beta_5 \text{MCtest} + \beta_6 \text{GPA} + \beta_7 \text{Taxassign} + \varepsilon$$

where:

Taxexam = percentage score in the final exam – tax component only

Gender = a dummy variable: 1 = male, 2 = female

Age = age of students

Taxknow = a dummy variable: 1 = never done tax before, 2 = did a tax course before

Onlinequiz = a dummy variable: 0 = those who did not attempt at least 2/3rds of the quizzes, 1= those who did

MCtest = percentage score on the multiple choice on-line test

GPA = GPA scores from 0 (Fail) to 9 (A+) at beginning of the 2010 semester

Taxassign = percentage score in tax assignment.

#### IV RESULTS

Table 1 (page 163) shows the profile of the students. There is a good representation of male (45%) and female students (55%). Since this course is a distance learning course, most students were working either full-time or part-time and it is expected that there will be more mature students than in a standard face to face university course. The average age was 37 and the majority of the students (73%) were 30 years old or more. About 71% of the students in this study had not enrolled in a tax course before, as this course caters primarily to the Graduate Diploma in Financial Planning. The balance of 29% must have self-selected to do this course. The academic performance of the students also varied, with an average GPA score of 4.5 (in Grade B category). The majority of students (56%) had a GPA grade in the B category, 22% in the A category and another 22% below the B category.

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<sup>56</sup> Above n 50.

**Table 1. Profile of students.**

	No.	%
<b>Gender</b>		
Male	51	45
Female	<u>62</u>	<u>55</u>
	<u>113</u>	<u>100</u>
<b>Age</b>		
20-29	30	27
30-39	43	38
40-49	28	24
50 and above	<u>12</u>	<u>11</u>
	<u>113</u>	<u>100</u>
<b>Prior tax knowledge</b>		
No	80	71
Yes	<u>33</u>	<u>29</u>
	<u>113</u>	<u>100</u>
<b>GPA grade*</b>		
A+ } A category	1	1
A } A category	7	6
A- } A category	17	15
B+ } B category	16	14
B } B category	20	18
B- } B category	27	24
C+ } C category	17	15
C } C category	7	6
R (restricted pass)	<u>1</u>	<u>1</u>
	<u>113</u>	<u>100</u>
<b>No. of on-line quiz questions completed before assignment due date</b>		
0% of quiz questions	69	61
1% -33% of quiz questions	16	14
Between 34%-66% of quiz questions	18	16
Between 67% and 99% of quiz questions	3	3
100% of quiz questions	<u>7</u>	<u>6</u>
	<u>113</u>	<u>100</u>
<b>No. of on-line quiz questions completed before exam</b>		
0% of quiz questions	23	20
1% -33% of quiz questions	10	9
Between 34%-66% of quiz questions	8	7
Between 67% and 99% of quiz questions	20	18
100% of quiz questions	<u>52</u>	<u>46</u>
	<u>113</u>	<u>100</u>

Disappointingly, the majority of the students (69%) did not use the on-line resources to self-assess their tax knowledge before the tax assignment was due. These interactive exercises were designed to help students reinforce their learning of each topic, and have relevance to the assignment question. The low participation rate could be due to work and family commitments perhaps taking priority for these students. Also from experience, a number of working students tend to do assignments very close to the due date. Only 9% of the students completed at least two thirds of the total interactive quizzes. In contrast, before the final exam, more students did the interactive quizzes, and perhaps they found that it was a good way to revise their studies. About 52% did all the quizzes and another 20% completed at least two thirds of all the quizzes. However, 23% did not attempt them at all.

Table 2 (below) shows the means and standard deviation ('SD') of the marks achieved by students in the summative assessments. The mean scores show that students performed better in the quiz than the tax assignment. Only two students did not submit the tax assignment and thus obtained zero scores. For the on-line quiz test, 96% of the students attempted all the MC questions. In contrast to student participation in the formative assessment, when no incentive was offered only five students chose not to submit their answers to the quiz. This finding suggests that where credit is given for on-line quizzes, most students would participate within the required time period. The mean score for the final exam (56%) was much lower than internal assessments as it was a totally closed book examination.

**Table 2. Means (SD) for marks.**

	Lowest mark (%)	Highest mark (%)	Mean <sup>57</sup> (%)	SD (%)
Tax Assignment	0.00	90.00	63.50	14.30
Quiz (Tax)	0.00	95.00	66.11	19.63
Final exam (Tax)	22.50	83.33	55.74	13.13

Table 3 (page 165) shows the breakdown of the tax exam score based on the students' profiles. Female students had a higher mean score than male students. Those under 30 years of age scored higher than those who were 30 and over. Furthermore, students with prior tax knowledge, and with higher GPA scores, achieved higher exam scores than those with no prior tax knowledge and lower GPA scores respectively. Finally, those who completed more quizzes performed better in the final exam than those who completed fewer. When students were further categorised into three groups: 'failed' students (achieved below 50% of tax exam marks), 'passed' students (50%–74%) and 'excelled' students (75% and above), the results were interesting. Out of the 10 excelled students, 8 (80%) did the on-line quizzes. For the 'pass' students, 42 out of 64 (66%) did the on-line quizzes. For the failed group 22 out of 39 (56%) did the on-line quizzes.

<sup>57</sup> The median for tax assignment, quiz and final exam are 66%, 70% and 55% respectively.



**Table 3. Breakdown of tax exam marks by student profile.**

	Marks %	SD
<b>Gender</b>		
Male	53	11.90
Female	58	13.80
<b>Age</b>		
20-29	57	15.10
30-39	55	12.60
40-49	56	11.70
50 and above	54	13.90
<b>Prior tax knowledge</b>		
Yes	59	12.10
No	54	13.40
<b>GPA grade</b>		
A category	69	8.60
B category	54	10.80
C category	46	11.20
R category	43	0.00
<b>No. of quiz questions completed before exam</b>		
0% of quiz questions	52	12.80
1% -33% of quiz questions	52	15.60
Between 34%-66% of quiz questions	55	8.42
Between 67% and 99% of quiz questions	56	12.90
100% of quiz questions	58	13.40

### 1 Regression

To examine the predictive power of each of the variables on the final exam score achieved by students, a linear multiple regression analysis was carried out. Table 4 (page 166) shows that a significant model emerged:  $F(6, 106) = 20.596$ ,  $p < 0.001$  and the model explains 53.8% of the variance.<sup>58</sup>

The results show that students' GPA was the best predictor of exam performance, followed by prior tax knowledge and tax assignment scores, after controlling for gender and age. GPA indicates students' ability in academic studies and therefore it is not surprising to find that good students in terms of academic ability tend to perform well in most subjects. Apart from that, those who had prior tax knowledge appeared to have a better understanding of tax concepts and were able to apply their understanding of the concepts to the scenario situations. These students, who self-selected into the course, perhaps had a real interest in tax and therefore were more motivated to do well than those for whom the course was compulsory. In contrast, quiz attempted<sup>59</sup> and quiz test

<sup>58</sup> The variance inflation factors (VIF) were checked and since they were within acceptable limits ( $VIF < 10$ ), there was no issue with multicollinearity.

<sup>59</sup> To test whether a difference would be found if students had completed at least 50% (instead of 67%) of the total quizzes, a separate test was carried out. However, there were no differences in the results. No significant differences were found even if this variable is used as a continuous variable.

score had no predictive power. These findings reinforce the claim in some studies that MC questions and CR questions test different cognitive processes.

**Table 4. Multiple regression analysis results.**

Model		B	Std Error	Beta	t-statistic	Sig.
1	(Constant)	17.155	6.318		2.715	.008
	Gender	1.714	1.733	.065	.989	.325
	Age	-.131	.090	-.100	-1.455	.149
	Taxknow	5.005	1.956	.174	2.559	.012*
	Onlinequiz	.021	.019	.077	1.099	.274
	MCtest	.031	.049	.046	.632	.528
	GPA	4.046	.680	.528	5.946	.000***
	Taxassign	.199	.078	.216	2.537	.013*

\* $p < 0.05$  \*\* $p < 0.01$  \*\*\* $p < 0.001$

## 2 Student feedback

A survey of students' perceptions of the on-line assessment was elicited from the students, also on-line. Some of the questions were modelled on the literature.<sup>60</sup> Eighteen students (16%) responded.<sup>61</sup> Table 5 (page 167) shows the results.

Generally, students who attempted or completed the on-line assessment resources found them to be useful in terms of providing feedback about learning and mastery of learning outcomes, identifying areas of weaknesses, etc. A huge majority (83%) thought they were valuable learning activities and only 39% thought they would attempt the quizzes only if credit was given for them. Some comments received from students which reinforced these points include:

I believe having one or more on-line quizzes for each of the topics covered in the course would be very useful for the distance learning student because it helps to test their knowledge of the topic and identify the areas they are weak in or have not understood properly.

It is also an efficient way to reinforce knowledge of key points in each topic.

...especially for extramural students [*i.e. distance learning students*] the quizzes provide fantastic feedback. I take the quizzes also as a hint of what subjects are important for the final exam.

Quizzes are great, given this paper covers rather broad topics, estate and tax.

<sup>60</sup> See, eg, Jonathan Kibble, 'Use of Unsupervised Online Quizzes as Formative Assessment in a Medical Physiology Course: Effects of Incentives on Student Participation and Performance' (2007) 31 *Advances in Physiology Education* 253.

<sup>61</sup> Some data was lost (9 in total which appeared blank) due to a technical error, and when it was discovered the next day, the survey was reset. Therefore a higher response would have been obtained if not because of the technical error.

Good mix of questions, valuable tool to understand the concept and learn from wrong answers.

Great tool that you can go back to time and again to reinforce understanding of the topics.

I found having explanations for why an answer was right/wrong EXTREMELY useful.

Quizzes are great for clarifying what rules are black and white. It felt like the course had a lot of grey areas and I was grateful that the quizzes helped clarify matters. Excellent way of making people engage with the course.

Students appeared to have a higher preference for on-line MC questions than yes/no or true/false type. However, only 11% of the students found the quizzes helpful in answering the tax assignment questions. One student pointed out the ambiguity of some questions:

For a quiz to be successful there needs to be a clear right answer. Some of the questions are ambiguous and therefore confusing and not helpful to my learning. I accept that some of the topics are not black and white — perhaps these more obscure concepts are inappropriate for short answer questions.

**Table 5. Students' perceptions of on-line assessment resources.**

Use of on-line quizzes	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Used them to give me feedback about my learning.	39%	44%	11%	6%	0%
They helped me to identify areas of weakness.	50%	28%	17%	6%	0%
They provide useful feedback to me about my mastery of the learning outcomes.	50%	28%	0%	11%	0%
They helped me to keep up with my studies.	28%	28%	17%	17%	0%
They helped me to learn the course material.	22%	61%	11%	0%	0%
They were a valuable learning activity.	61%	22%	6%	11%	0%
Giving credit for the quizzes will make it more likely for me to attempt them.	22%	17%	22%	22%	11%
I had a better grasped of the topic after going through the quizzes.	56%	22%	17%	0%	0%
The quizzes, to a certain extent, helped me to answer Assignment 2 questions.	0%	11%	17%	33%	11%
I think the yes/no questions are most helpful in reinforcing what I have read about the topic area.	0%	39%	44%	11%	0%
I think the true/false questions were most helpful in reinforcing what I have read about the topic.	11%	22%	44%	11%	0%
I think the MC questions were most helpful in reinforcing what I have read about the topic area.	28%	33%	17%	11%	6%

The author accepts the ambiguity of some MC questions, especially those which were set to assess higher learning objectives. MC questions in taxation are certainly more difficult to construct, particularly if one wants to assess higher level thinking and analytical skills. Some types of question might be better asked in a CR question form, as certain tax decisions require justifications and support from the tax law.

## V CONCLUSION

Extant literature on student learning and motivation supports the use of on-line assessment such as MC questions as it provides instant feedback, enabling students to assess their own strengths and weaknesses in their understanding of the subject matter so that they can improve future performance. This study was carried out to examine the use of on-line learning opportunities by tax students and to determine whether participation helped students in their performance in the final examination. Students' performance in an MC test, and its relationship with their examination scores, was also examined. The results revealed that use of on-line quizzes and the MC test were not good predictors of examination scores. Instead, students' GPA stood out as the most important predictor of performance in the examination, which is consistent with many prior studies in accounting courses.<sup>62</sup> Other significant predictors were the CR type tax assignment and prior tax knowledge. Students with high GPA scores perhaps have a good mastery of all the different cognitive levels, from knowledge to evaluation, compared to those with lower GPA scores. The literature further indicates that those with a strong academic record tend to be those who are more motivated and willing to put more effort into their studies.<sup>63</sup> Prior tax knowledge may also serve as motivation, as students who have completed an introductory taxation course before and have self-selected into this course appear keen to learn more about the subject.

The finding that MC test scores are not a predictor of student performance indicates that MC assessment is not a good surrogate for CR assessment. This result is consistent with those studies that found no relationships,<sup>64</sup> but inconsistent with those that found positive relationships.<sup>65</sup> As pointed out by Bible et al,<sup>66</sup> it is important to consider the nature of the CR questions used in the exam when making comparisons with the findings of prior studies. Results could be different due to the type of assessments and the disciplines in which they are used, or due to the level of educational objectives set for MC and CR questions.<sup>67</sup> Both the exam questions and the tax assignment questions in this study required students not only to have knowledge and understanding of the tax law but also to be able to apply it, as well as to analyse and evaluate the various tax situations. Furthermore, with numerous exceptions to tax rules, there is not always one correct answer. Sometimes answers to a tax scenario could be different if valid assumptions are made. Therefore CR questions are more suitable for assessing students' ability to construct a logical argument or justification. MC tests and quizzes have more to

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<sup>62</sup> See, eg, Kealey et al, above n 53.

<sup>63</sup> See, eg, Brookshire and Palocsay, above n 53.

<sup>64</sup> See, eg, Becker and Johnston, above n 38; Kuechler and Simkin, above n 53; and Sangster, above n 40.

<sup>65</sup> See, eg, Bible et al, above n 5 and Buchanan, above n 9.

<sup>66</sup> Above n 5.

<sup>67</sup> See, eg, Kuechler and Simkin, above n 12.

do with the first three cognitive levels, ie knowledge, comprehension, and application. This perhaps explains why quizzes are not significant predictors of examination performance. Using MCQ as a surrogate for CRQ therefore is not appropriate for a taxation course which requires students not only to be able to evaluate a tax situation, but also to provide justifications for their answers to various tax scenarios set in the assignment or examination questions.

Does this mean that MC questions or other forms of on-line interactive exercises are not useful for learning purposes, as they do not help students to perform better on course assessments and examinations? Although they did not play a significant role in exam performance, as shown in this study, students' feedback suggests that there are students who like a combination of various on-line activities, and there is a preference for MC type questions. This is more the case for distance learning students who are working on their own, as it can be extremely frustrating not knowing whether one is on the right track. Also, as students may have different learning approaches, providing a diverse range of assessments allows students to tailor their use to their own learning style and also helps to reduce student anxiety.<sup>68</sup> Furthermore, students generally like to see a range of assessment opportunities as it helps to keep them motivated in their studies.<sup>69</sup> These types of interactive assessments provide good support for self-regulated learning.<sup>70</sup> It is, however, challenging for tax teachers to write MC questions to assess outcomes at the higher cognitive levels. Coming up with plausible distracters requires a certain amount of skill and it is time consuming. MC questions are perhaps more suitable for testing a student's achievement at the lower level, such as simple recall of facts, and understanding of tax concepts.

The other interesting finding from this study is that incentives (course credit of a certain percentage) provided for on-line quizzes increases student participation. The interactive quizzes were set with the good intentions of helping students in learning the subject and the author thought most students would want to attempt them before the tax assignment was due. Having said that, the majority of distance learning students worked full-time and they had to juggle and prioritise their time between study, work, and family. When no credit was awarded for the quizzes, attempts appeared to be of low priority but when credit was awarded, students completed the quizzes on time. However, when it came to studying for the examination, a huge majority used them for revision purposes. This approach to learning is rather similar to what Entwistle and Ramsden<sup>71</sup> and Biggs<sup>72</sup> termed as the strategic approach, as students who want to do well in the course are guided by an awareness of assessment criteria. Many distance

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<sup>68</sup> See, eg, Roy Clariana, 'A Review of Multiple-try Feedback in Traditional and Computer Based Instruction' (1993) 20 *Journal of Computer-Based Instruction* 76; Peat and Franklin, above n 8; and Stan Zakrzewski and Joanna Bull, 'The Mass Implementation and Evaluation of Computer-Based Assessments' (1999) 23 *Assessment and Evaluation in Higher Education* 141.

<sup>69</sup> See, eg, Jane Seale, Judith Chapman and Christine Davey, 'The Influence of Assessments on Students' Motivation to Learn in a Therapy Degree Course' (2000) 34 *Medical Education* 614.

<sup>70</sup> See, eg, Nicol, above n 7.

<sup>71</sup> Noel Entwistle and Paul Ramsden, *Understanding Student Learning* (C Helm; Nichols Publishing Company, 1982).

<sup>72</sup> John Biggs, *Student Approaches to Learning and Studying* (Australian Council for Educational Research, 1987).

learning students in particular are, of necessity, strategic in their approach to learning.<sup>73</sup> An interesting question is raised at this point: should distance learning students be left to self-regulate their own learning or should the educator look at ways to encourage student participation at an earlier stage? There are indeed no hard and fast rules as to which is the best approach but it is a question which every teacher needs to ask in order to decide which is more appropriate for their course.

This study examined distance learning students enrolled in a taxation course in one university only. Therefore the findings may not be generalisable to other universities, disciplines, or to on-campus students. Future studies could extend to more advanced tax courses or to on-campus students. Furthermore, the design employed in this study is a 'between subjects' design, and therefore the findings did not tell us whether the examination scores of the same student improved because the student attempted the quizzes and learned from the feedback. For instance, to examine whether the quizzes helped the weaker students would require a 'pre- and post-test' design. Another interesting aspect was that when students were grouped into failed, passed, and excelled students, it was found that 22 students who attempted the on-line quizzes still failed the final examination. Does this mean that they just attempted the quizzes without reflecting on the feedback? Examining the learning approaches or styles of students who achieved a fail, pass, or excellent grade and using a longitudinal study may provide further insights into how students engage with their studies on-line, including the use of interactive exercises and the benefits they reap from such engagement in terms of enhancing their learning and development.

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<sup>73</sup> See, eg, Mark Stansfield, Evelyn McLellan, and Thomas Connolly, 'Enhancing Student Performance in Online Learning and Traditional Face-to-face Class Delivery' (2004) 3 *Journal of Information Technology in Education* 173.

**SHOW ME THE EVIDENCE:  
HOW THE SCHOLARSHIP OF LEARNING AND TEACHING IS CRITICAL FOR MODERN ACADEMICS**

DR BRETT FREUDENBERG\*

**ABSTRACT**

Good teaching is of itself not enough in modern university environments. More and more, academics are being asked to provide evidence of learning and teaching outcomes, as well as being engaged in the scholarship of teaching.

While academics may be well versed in researching their own disciplines, they may be hesitant about how to approach researching their own teaching methods and strategies and how this has influenced student learning. This paper will outline and provide examples about how the scholarship of learning and teaching (‘SoLT’) can be approached. This will include discussing the different research methodologies that can be utilised as evidence learning and teaching outcomes.

The paper then considers how modern academics can leverage off the SoLT to further their academic careers, and how it can be important in terms of research output, promotion, award applications, and own teaching practices. The author argues that it is critical for modern academics to be more proactive in researching their teaching practices, as they will be called upon increasingly to show evidence of the learning outcomes in their classrooms.

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## I INTRODUCTION

As in other countries, the tertiary sector in Australia has, in the pursuit of increased economic returns, been subject to reforms based on economic rationalism.<sup>1</sup> These can be traced back to John Dawkins, Minister for Employment, Education and Training in 1987-88, with the release of two government policy papers: *Higher Education: A policy discussion paper* and *Higher Education: Policy statement*.<sup>2</sup> This new 'economic' environment can be seen as a stark contrast to the historical perception of the tertiary sector as an elite activity with high levels of autonomy and little directed financial support from government and industry.<sup>3</sup>

This background of reform has seen Australian universities adopt corporate management principles and practices,<sup>4</sup> including corporate forms of work organisation (both for internal and external transactions), corporate management practices, and aggressive engagement in entrepreneurial activities, such as consulting and marketing their education services internationally.<sup>5</sup>

In order to measure the economic performance of the sector's outputs, key performance indicators ('KPIs') have been created and implemented on a number of fronts.<sup>6</sup> For teaching, these KPIs typically cover graduate feedback about teaching, course pass and retention rates, and levels of graduate employment. For research KPIs, the volume and status of publications and research grants have been used. This can mean that academics are increasingly measured on outputs, although when it comes to measuring good teaching and learning outcomes for students, it can be problematic to convert what is happening in the classroom to simple KPI numbers.

Overall, what this means is that good teaching is of itself not enough in modern university environments. Increasingly, academics are being asked to provide evidence of learning and teaching outcomes, and also to be engaged in the scholarship of teaching. There are also public calls for accountability in higher education, where questions 'about

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<sup>1</sup> John Biggs, 'Corporatised universities: an educational and cultural disaster' in J Biggs and R Davis (eds.), *The Subversion of Australian Universities*, Chapter 12, (2002) 184-222, 194; Alan Skelton, 'Understanding 'teaching excellence' in higher education: a critical evaluation of the National Teaching Fellowships Scheme' (2004) 29(4) *Studies in Higher Education* 451, 452.

<sup>2</sup> Maarja Soo, *The Effect of Market-based Policies on Academic Research Performance: Evidence from Australia 1992-2004* (University of North Carolina, Chapel Hill, 2008) 10.

<sup>3</sup> Peter Coaldrake and Lawrence Stedman, *Academic Work in the Twenty-first Century* (1999) <http://www.dest.gov.au/archive/highered/occpaper/99H/academic.pdf>. 3.

<sup>4</sup> Richard Winter and James Sarros, 'The Academic Work Environment in Australian Universities: A motivating place to work?' (2002) 21(3) *Higher Education Research & Development* 241.

<sup>5</sup> Ibid. Michael Gallagher, 'The emergence of entrepreneurial public universities in Australia' (Paper presented at the IMHE General Conference of the OECD, Paris, September 2000), *DETYA Occasional Paper Series* (2000); Simon Marginson and Mark Considine, *The enterprise university: Power, governance and reinvention in Australia* (Cambridge: Cambridge University Press, 2000).

<sup>6</sup> Phil Hancock, Bryan Howieson, Mary Kavanagh, Jenny Kent, Irene Tempone, Naomi Segal and Mark Freeman, 'The Roles of Some Key Stakeholders in the Future of Accounting Education in Australia' (2009) 19(3) *Australian Accounting Review* 249, 250.



pedagogical effectiveness' have been raised.<sup>7</sup> In particular, international accreditation agencies are looking for more substantial evidence in terms of learning outcomes.<sup>8</sup>

The scholarship of learning and teaching ('SoLT') is seen as one way of providing evidence of learning and teaching outcomes.<sup>9</sup> By engaging in the SoLT, academics can be more active agents: this can have beneficial implications in terms of their teaching and of student learning, but also can raise their research profile. However, the SoLT is not without its detractors, such as confusion about what it is, its position with respect to research, and what role it plays for academics. For example, in 2000 it was stated that academics in Australia and Britain had only a vague notion of what constituted SoLT.<sup>10</sup> More recently Boyer asserted that 'most university faculty members or academic staff do not know' the meaning of SoLT.<sup>11</sup> This paper seeks to decipher the meaning of the SoLT, its relationship to academia, and how it may play a role in improving academia for all stakeholders.

It will be argued that SoLT is important in the modern university environment, with the vast challenges that environment presents to academics. Particularly, SoLT can help to provide more robust evidence about how best these challenges can be addressed:

If students are to be adequately prepared for life, work, and civic participation in the twenty-first century, colleges and universities must pay closer attention to the heart of the educational enterprise. ... The scholarship of teaching and learning brings powerful new principles and practices to ground deliberations ... in sound evidence and help point the way.<sup>12</sup>

This paper will firstly discuss what the meaning of SoLT is and how it relates to research and the academic's role in the tertiary sector. The paper will then discuss how academics can approach the SoLT, reflecting on some of the different theories and methodologies that can be utilised. The third section of the paper considers how modern academics can leverage off their SoLT to advance not only student learning but also their own personal endeavours. It will be argued that an understanding of and engagement with the SoLT is a critical component for academic success.

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<sup>7</sup> Mary Huber and Sherwyn Morreale, 'Situating the Scholarship of Teaching and Learning: A Cross-Disciplinary Conversation' in *Disciplinary Styles in the Scholarship of Teaching and Learning: Exploring Common Ground* (2002) 3, <<http://www.carnegiefoundation.org/elibrary/situating-scholarship-teaching-and-learning-cross-disciplinary-conversation-disciplinary-st>>.

<sup>8</sup> Association of Advance Collegiate Schools of Business (AACSB), *Business Accreditation Standards 15-21* (2011) <<http://www.aacsb.edu/accreditation/business/standards/aol/>>.

<sup>9</sup> Previously, this scholarship was referred to as the 'scholarship of teaching and learning' (SoTL). However, in recent years this has been altered to represent that the emphasis should be on student 'learning' before the 'teaching' practices – represented by reconfiguration to 'scholarship of learning and teaching' (SoLT). For consistency, this article uses SoLT.

<sup>10</sup> Keith Trigwell, Elaine Martin, Joan Benjamin and Michael Prossner, 'Scholarship of teaching: a model' (2000) 19(2) *Higher Education Research and Development* 155, 156.

<sup>11</sup> Roger Boshier, 'Why is the scholarship of teaching and learning such a hard sell?' (2009) 28(1) *Higher Education and Research* 1, 1.

<sup>12</sup> Pat Hutchings, Mary Huber and Anthony Ciccone, *The Scholarship of Teaching and Learning Reconsidered* (Jossey-Bass: San Francisco, 2011), 3.

## II SCHOLARSHIP OF LEARNING AND TEACHING ('SoLT')

Trigwell and others have stated that the aim of SoLT is simple:

it is [to] make transparent how we have made learning possible. For this to happen, university teachers must be informed of the theoretical perspectives and literature of teaching and learning in their discipline, and be able to collect and present rigorous evidence of their effectiveness, from these perspectives, as teachers. In turn, this involves reflection, inquiry, evaluation, documentation and communication. A model of the scholarship of teaching offers a framework for making transparent the process of making learning possible.<sup>13</sup>

However, the simplicity of this statement masks the debates and confusion that have arisen since Boyer first used the term 'scholarship of teaching' in 1990.<sup>14</sup> In Boyer's original discussion there were four potential types of scholarship: 'discovery', 'integration', 'application' and 'teaching'.<sup>15</sup> 'Discovery' is closely associated with the traditional notions of research leading to the advancement of knowledge.<sup>16</sup> The notion of 'integration' is about 'illuminating the data in a revealing way', which can place it in a broader context.<sup>17</sup> 'Application' is aimed at applying knowledge to solve problems for both individuals and institutions.<sup>18</sup> The fourth type of scholarship, 'teaching', is about ensuring that there is a 'continuity of knowledge' to others.<sup>19</sup>

Part of the confusion about SoLT is that it is being used as a 'synonym for other activities'.<sup>20</sup> Despite this confusion, a more settled understanding of SoLT has emerged:

The scholarship of teaching is problem posing about an issue of teaching or learning, study of the problem through methods appropriate to disciplinary epistemologies, application of results, self-reflection and peer review.<sup>21</sup>

To clarify, Wilson points out that a 'scholarly approach *to* learning and teaching' is different to the 'scholarship *of* learning and teaching' (emphasis added).<sup>22</sup> A 'scholarly approach to learning and teaching' entails being familiar with the literature about education and learning and then implementing this into teaching practices, whereas a 'scholarship of learning and teaching' extends beyond this to 'critical reflection/reflective practice' and 'production of generalisable knowledge as a by-product'.<sup>23</sup> This notion is represented by Trigwell et al's explanation of SoLT:

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<sup>13</sup> Trigwell, Martin, Benjamin and Prossner, above n 10, 156.

<sup>14</sup> Ernest Boyer, *Scholarship reconsidered: priorities of the professoriate* (Princeton, Carnegie Foundation for the Advancement of Teaching, 1990) 16.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid, 17.

<sup>17</sup> Ibid, 18.

<sup>18</sup> Ibid, 23.

<sup>19</sup> Ibid, 24.

<sup>20</sup> Boshier, above n 11, 2-3.

<sup>21</sup> Barbara Cambridge, 'Fostering the scholarship of teaching and learning: Communities of practice' in D Lieberman and C Wehlburg (eds) *To Improve the Academy* (Bolton, Anker, 2001).

<sup>22</sup> Keitha Wilson, *Practising the Scholarship of Learning & Teaching: A personal journey* (Griffith Institute for Higher Education, Griffith University, 2010) 9.

<sup>23</sup> Ibid.

Teachers who are more likely to be engaging in scholarship of teaching ... seek to understand teaching by consulting and using the literature on teaching and learning [this is a 'scholarly *approach to*'], by investigating their own teaching, by reflecting on their teaching from the perspective of their intention in teaching while seeing it from the students' position, and by formally communicating their ideas and practices to their peers [this is 'scholarship *of*'].<sup>24</sup> (Comments in square brackets are the author's.)

Consequently, SoLT clearly has a research component to it, where academics investigate/research the learning and/or teaching implications of their practices or innovations. This understanding is reflected in one Australian university's explanation of the SoLT:

The scholarship of learning and teaching involves **research into practices** of teaching, learning and curriculum. It involves:

- **Asking questions** about how your students learn and how best to enhance learning through effective teaching
- **Gathering and interpreting evidence** about student learning from a range of sources
- **Sharing the results** of your analysis publicly for the purpose of peer review and to share the body of knowledge with colleagues and the academic community.<sup>25</sup>

(Emphasis added)

Part of the reason that the SoLT has been problematic or may not have achieved penetration into the academic consciousness is due to confusion about it. Further, Boshier has highlighted that some academics perceive SoLT as 'a fallback route to promotion for people with patchy research records'.<sup>26</sup> For those who champion SoLT this has led to frustration.<sup>27</sup> For example, SoLT may be 'marginalized from "true" scholarship in the eyes of the institutional or disciplinary peers' as SoLT work 'may not evoke the same respect or carry the same weight as traditional scholarship'.<sup>28</sup> This 'poor cousin' approach can lead to some institutions not acknowledging or recognising refereed publications on SoLT as research output when the academic's main field of study is discipline-specific.<sup>29</sup> This raises questions about what the relationship is between SoLT and research, and if there are substantive differences between the two. Gurm has persuasively argued that SoLT has been positioned as the 'other' compared to research, which can imply that SoLT is somehow inferior.<sup>30</sup>

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<sup>24</sup> Trigwell, Martin, Benjamin and Prossner, above n 10, 164.

<sup>25</sup> Margaret Buckridge and Kerrie-Lee Krause, *Good Practice Guide: Scholarship of Learning and Teaching (SOLT)* (Griffith Institute of Higher Education, Griffith University, 2010) 1.

<sup>26</sup> Boshier, above n 11, 1.

<sup>27</sup> Pat Hutchings and Lee Shulman, 'The scholarship of teaching' (1999) September/October *Change* 11.

<sup>28</sup> Connie Schroeder, 'Countering SoTL marginalization: A model for integrating SoTL with institutional initiatives' (2007) 1(1) *International Journal for the Scholarship of Teaching and Learning* 1, 1; Balbir Gurm, 'Is all Scholarship equally valued? Fusion of horizons on the definition and status of scholarship' (2009) 3(2) *International Journal for the Scholarship of Teaching and Learning* 5–6.

<sup>29</sup> Neil Haigh, *The Scholarship of Teaching & Learning: A practical introduction and critique* (AUT University, Auckland, 2010) 9.

<sup>30</sup> Gurm, above n 28, 6.

Firstly, SoLT can be distinguished from 'disciplinary knowledge', the expert knowledge that academics have about their discipline, which can be based on their own studies, industry experience, and research into the area. The SoLT refers to understanding of and research into the process of learning and teaching, which may include 'how students learn' or 'how learning systems work' in that discipline.<sup>31</sup> Discipline knowledge (and the research into the discipline) is a traditional foundation for what being an academic is about and how 'research' output is measured.

It is argued that (pragmatically) SoLT is essentially an area of research, and should be approached and recognised as such. This is similar to how academics over the course of their careers extend and move into other areas beyond their initial PhD research. To pigeonhole research into specific discipline areas is artificial and does not acknowledge the vast area of research topics and research methodologies that academics will cover over the duration of their careers.

One argument to discredit SoLT is the use of 'critical reflection' within it.<sup>32</sup> However, it is argued that critical reflection as a part of SoLT is a type of research, albeit rudimentary. Indeed, this is part of the acknowledgement that SoLT often involves 'action research' as it involves reflection in action, as academics investigate the learning that is occurring in their classes.<sup>33</sup> Kreber points out that critical reflection can be lifted if it extends beyond the academic's own practices to the theoretical knowledge derived from research.<sup>34</sup> For, as Haigh points out, this process can 'generate knowledge', which is an important part of any research regardless of discipline.<sup>35</sup>

Part of this problem may be traced to how the traditional role of an academic has been divided between research, teaching and service, reflected by a 40:40:20 split. This has been referred to as the 'scarcity model'<sup>36</sup> which sees research and teaching at odds with each other, bidding for the academic's time.<sup>37</sup> A problem with this idea is that it provides an artificial distinction between research, teaching, and service, which is not a useful dichotomy as modern academics struggle to meet the demands they face.

SoLT questions have 'muddied the water' further, with Huber pointing out that SoLT possibly could be counted within all three traditional demarcations of academic work: 'research', 'teaching', and 'service'.<sup>38</sup> Huber argues that difficulties will continue for work that 'crosses the boundaries', and that it is necessary to 'rethink old categories if the academy wants to produce new kinds and forms of knowledge'.<sup>39</sup>

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<sup>31</sup> Wilson, above n 22, 4.

<sup>32</sup> Haigh, above n 29, 5-6.

<sup>33</sup> Donald Schon, 'The new scholarship requires new epistemology' (1995) November/December *Change* 27.

<sup>34</sup> Carolin Kreber, 'Developing the scholarship of teaching through transformative learning' (2006) 6(1) *Journal of Scholarship of Teaching and Learning* 88.

<sup>35</sup> Haigh, above n 29, 6.

<sup>36</sup> John Hattie and Herb Marsh, 'The relationship between research and teaching: a meta-analysis' (1996) 66(4) *Review of Education Research* 507.

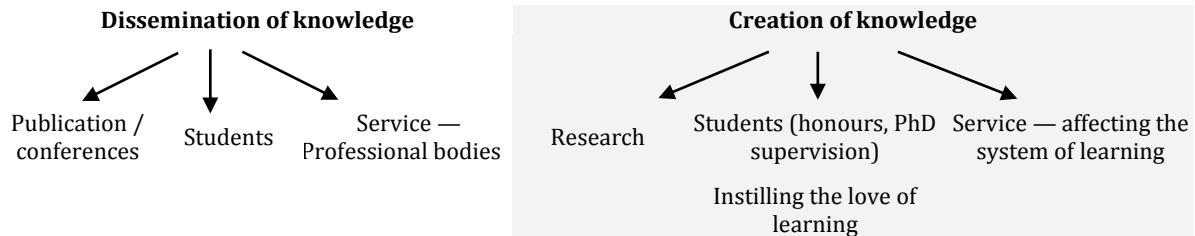
<sup>37</sup> Coaldrake and Stedman, above n 3, 20.

<sup>38</sup> Mary Huber, 'Balancing Acts: Designing Careers Around the Scholarship of Teaching' (2001) 33(4) *Change* 21, 25.

<sup>39</sup> *Ibid* 27.

It is argued that Romainville provides a useful way to re-consider the dual functions of universities — ‘knowledge creation’ and ‘knowledge transmission’ — rather than the traditional demarcation.<sup>40</sup> This dual function, and how it can be achieved, are illustrated in Figure 1.

**Figure 1**



While Figure 1 may represent an academic’s role in only a slightly different way to the ‘traditional model’ referred to, it provides a greater integration of the three ‘traditional’ areas of research, teaching, and service. It is submitted that this integration is a more informative way to consider an academic’s role. For example, within the ‘dissemination of knowledge’ are included publications, conferences, students, and service to the profession. Included in terms of ‘creation of knowledge’ are research, supervising higher degree students (honours, PhD), and instilling a love of learning and service through effecting the system of learning. Through this perspective, a more complete meaning of ‘creating and disseminating knowledge’ is understood. It is argued that the integrationalist view of Ramsden & Moses<sup>41</sup> is preferable; that [good] teaching and research are mutually reinforcing or symbiotic, and that SoLT is clearly an activity that emulates this:

Good university teaching, the argument goes, can only be undertaken by active researchers, and research activity is strengthened through interactions between the researcher and students.<sup>42</sup>

It seems a strange disconnect for academics, who by their nature should be inquisitive, not to take a more objective and informed position in terms of what is occurring in their classrooms. This is particularly the case when ‘teaching’ constitutes traditionally 40 per cent of their work. Shulman argues that it is fundamental for academics to engage in SoLT, for reasons of professionalism, pragmatism, and policy.<sup>43</sup> Provocatively, Shulman questions the ‘integrity’ of an academic who does not ‘examine the impact of his or her work on the students’.<sup>44</sup> He succinctly states that SoLT helps academics fulfil their role as

<sup>40</sup> Marc Romainville, ‘Teaching and research at university: A difficult pairing’ (1996) 8 *Higher Education Management* 135.

<sup>41</sup> Paul Ramsden and Ingrid Moses, ‘Associations between research and teaching in Australian higher education’ (1992) 23 *Higher Education* 273.

<sup>42</sup> Coaldrake and Stedman, above n 3, 19.

<sup>43</sup> Lee Shulman, ‘From Minsk to Pinsk: Why a scholarship of teaching and learning?’ (2000) 1 *Journal of Scholarship of Teaching and Learning* 48.

<sup>44</sup> Lee Shulman, ‘Forward word’ in P Hutchings (ed). *Ethics of inquiry: Issues in the scholarship of teaching and learning* (Menlo Park, CA: The Carnegie Foundation for the Advancement of Teaching, 2002) vii.

stewards of their disciplines, sustaining that 'quest for integrity'.<sup>45</sup> This point is reiterated by Hutchings and others:

[T]eaching is not just technique ... but an enactment of our understanding of our disciplinary, interdisciplinary or professional field and what it means to know it deeply.<sup>46</sup>

In terms of 'policy', Shulman argues that, in respect of audits of learning (which are becoming more prevalent for international, national, and state accreditation), without SoLT the 'wrong indicators ... [could be] used to assess the quality of our efforts', which may be due to convenience or economy of use.<sup>47</sup> Through SoLT, academics have the opportunity to ensure that more robust measures of learning and teaching outcomes are provided, rather than 'easy' KPIs, which may be misleading.

It should be appreciated that undertaking SoLT does not of itself guarantee improved learning and/or teaching outcomes as the research results may indicate that the practice implemented had no or negative outcomes.<sup>48</sup> However, as with any research, such outcomes are informative, not only for the academic involved, but also to others, and enable better practices to be adopted in the future.

### III APPROACHES TO SoLT

An issue that can confront academics about engaging in SoLT is their familiarity (or the lack thereof) with what it actually means, and with pedagogical theory in general. While academics may have strong discipline knowledge, many academics may have limited knowledge of theories of learning and strategies of teaching.<sup>49</sup> Research has demonstrated that even those academics identified as excellent teachers may have only 'sketchy knowledge' of the literature.<sup>50</sup> However, it is argued that even these excellent teachers would benefit from engaging with SoLT. This is because they need to be able to provide robust evidence of why their practices are good, and the SoLT can assist with framing this to ensure that they are given due credit for their achievements.

Furthermore, expertise in a field or discipline does not itself guarantee that academics can convey this knowledge to their students:

Last semester I was lucky in that I had lecturers who were passionate about their teaching but were good at teaching, whereas this semester I've had a couple who have been really

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<sup>45</sup> Ibid, viii.

<sup>46</sup> Pat Hutchings, Marcia Babb and Chris Bjork, 'The Scholarship of Teaching and Learning' in *Higher Education: An Annotated Bibliography* (The Carnegie Academy for the Scholarship of Teaching and Learning, 2002) 2, <[http://www.ipfw.edu/celt/learning/PDFs/solt\\_carnegie.pdf](http://www.ipfw.edu/celt/learning/PDFs/solt_carnegie.pdf)>.

<sup>47</sup> Shulman, above n 43, 52.

<sup>48</sup> Spencer Benson, *Defining the scholarship of teaching and learning in Microbiology* (2001) 2, <<http://www.microbelibrary.org>>.

<sup>49</sup> Ray Ballantyne, John Bain and Jan Packer, 'Researching University Teaching in Australia: themes and issues in academics' reflections' (1999) 24(2) *Studies in Higher Education* 237; R Edgerton, 'Melange' (1988) April 20 *The Chronicle of Higher Education* B2; Richard Light, *The Harvard Assessment Seminars: explorations with students and faculty about teaching, learning and student life* (Cambridge: Harvard University, 1990).

<sup>50</sup> Skelton, above n 1, 464.

good in their field but not good at conveying to the students, which puts you off, [and] confuses a lot of students ...<sup>51</sup>

This lack of pedagogical knowledge may lead academics to teach as they were taught. Even if academics themselves were taught well, given the changes in universities and student populations it is questionable whether this will be effective to address modern challenges.<sup>52</sup> This highlights the importance of SoLT: it is critical that academics do not perpetuate poor learning and teaching practices, and that they alter such practices to address current challenges, for without critical reflection involved in SoLT it is questionable whether high-quality student learning is occurring.<sup>53</sup>

It is argued that academics can build upon their prior skills and knowledge (and research) so as to engage in SoLT. This symbiotic nature between teaching and research can lead to enhancements, as it has been stated that 'higher education's teaching and service performance will be strengthened ... if faculty are encouraged to approach their work in the classroom and community with the same care and curiosity that they bring to library, laboratory, studio, or field.'<sup>54</sup> Many universities have now established centres to support and develop the educational knowledge of those in the tertiary sector. These learning centres can offer professional development of teaching from workshops, graduate certificates, masters, and doctoral programs.

One criticism of SoLT is that it can be discipline specific, which reduces the 'research' value of findings from it.<sup>55</sup> Academics need to be mindful to address this: there is fertile ground to share amongst disciplines as there are common teaching and learning issues faced by academics regardless of their discipline. Having a more interdisciplinary approach with regards to methodology and literature may indeed lead to new collaborations and solutions.<sup>56</sup> While it is agreed that SoLT can occur in a specific discipline context, what is needed is a broad educational literature and theoretical basis to test and use in such a context. Through this, academics' SoLT can be positioned in the broader context of pedagogical research.<sup>57</sup> This includes ensuring that appropriate terminologies (keywords) are used to fit within the existing literature.<sup>58</sup>

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<sup>51</sup> Louise Horstmanshof, *An Examination of the Effectiveness of Lecturers for Large First Year Classes* (Griffith University, 2010) 16.

<sup>52</sup> These modern challenges include: a diversification and need for universities to raise their own funding, and the changing student cohort (such as increased outside working hours, family commitments, and increased international student numbers). See: Biggs, above n 1.

<sup>53</sup> Herman Wentzel, 'Seminars in college teaching: an approach to faculty development' (1987) 35 *College Teaching* 70.

<sup>54</sup> Huber, above n 38, 21.

<sup>55</sup> Lorraine Gilpin, 'Reflective, reflexive and recursive: the praxis of SoTL' (2009) 5(3) *The International Journal of the Scholarship of Teaching and Learning*.

<sup>56</sup> Huber and Morreale, above n 7.

<sup>57</sup> Michael Prosser, 'The scholarship of teaching and learning: What is it? A personal view' (2008) 2(2) *International Journal for the Scholarship of Teaching and Learning*; Mary Huber and Pat Hutchings, 'Surveying the Scholarship of Teaching and Learning' in the *Advancement of Learning: Building the Teaching Commons* (San Francisco: Jossey-Bass, 2005) 1-16.

<sup>58</sup> Royce Sadler, *Research into University Teaching & Learning* (Griffith Institute for Higher Education, Griffith University, 2010).

Positioning a research project into the broader literature is an essential component for any academic research. In terms of a particular SoLT project being discipline specific, really this is just a potential limitation of SoLT, which is that the findings may only be relevant to the specific discipline. Nevertheless it is possible to espouse how such results may be relevant to other disciplines that share characteristics. For example, the scholarship of learning in tax courses may be relevant to other commercial law courses offered in business schools. Gurm, in her article, notes that for her the German meaning of scholarship, which implies it is 'supra disciplinary in nature', relates more to her understanding of SoLT than the English meaning, which is more discipline specific.<sup>59</sup> Sadler agrees that for SoLT to be meaningful, it is essential to explain how the research may have broader implications beyond the discipline in question.<sup>60</sup>

#### IV EDUCATIONAL THEORY

Accordingly, a literature review is critical for academics to establish a gap and the need for inquiry. This includes highlighting the originality of the work and how it adds to the body of existing literature. Below is an outline of some of the literature that may be useful to position a SoLT project, particularly literature on the process of learning, self-efficacy, work integrated learning ('WIL'), student motivation, and generic skills. For example, Fong provides a detailed review of the tax scholarship that has occurred in Australia and New Zealand.<sup>61</sup>

A basis for the SoLT could be students' process of learning and how this occurs: what are the elements that assist it, as well as those that impede it? This research need not just analyse the students' learning but can consider how the curriculum and assessments affect learning. For example, Williams states that 'the curriculum should focus on the process of learning, not just teaching answers'.<sup>62</sup> Popular literature about learning and teaching includes Biggs' approaches to learning to encourage the development of deeper learning approaches by students.<sup>63</sup> His 3 P model describes learning systems via (a) Presage, (b) Process, and (c) Product.<sup>64</sup> For the tax discipline this has included

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<sup>59</sup> Gurm, above n 28, 5.

<sup>60</sup> Sadler, above n 58.

<sup>61</sup> Colin Fong, 'Taxation Scholarship in Australia and New Zealand: A preliminary view' (Paper presented at the 14th Annual Australasian Tax Teachers' Association 2002 Conference, Manukau Business School, Auckland, 17-19 January 2002).

<sup>62</sup> DZ Williams, 'Strategies for Change in Accounting Education: The U.S. Experiment' in Jane O. Burns and Belverd E. Needles, *Accounting Education For the 21st Century: The Global Challenges* (New York, International Association for Accounting Education and Research, 1994) 207, 208.

<sup>63</sup> John Biggs, 'Individual differences in study processes and the quality of learning outcomes' (1979) 8 *Higher Education* 381.

<sup>64</sup> John Biggs, 'Approaches to Enhancement of Tertiary Teaching' (1989) 8(1) *Higher Education Research and Development* 7.



considering the role of conceptual versus technical knowledge,<sup>65</sup> the use of drawings,<sup>66</sup> and different delivery modes.<sup>67</sup>

Another way to consider learning is through information literacy, where people use information through critical thinking, analysis, and synthesis in order to solve problems and make decisions.<sup>68</sup> There is a growing awareness of the importance of information literacy education for students, particularly as information literacy is inextricably associated with information practices and critical thinking in the information and communication technology ('ICT') environment.<sup>69</sup> Bruce contends that 'information literacy is conceivably the foundation for learning in our contemporary environment of continuous technological change ... it is pivotal to the pursuit of lifelong learning, and central to achieving both personal empowerment and economic development'.<sup>70</sup> The framework of information literacy, with its six standards, has been used to consider how business professionals use, find, and create new knowledge in terms of tax.<sup>71</sup> Sharp and Datt demonstrate how different assessment items can provide powerful motivators for students to engage in research and critical thinking — essential components of information literacy.<sup>72</sup>

Also, research can consider how students interact with theory, in terms of recalling as well as applying it. For example, concept knowledge has been described as 'the mental processes ranging from simple recall or awareness to creative thinking or evaluation', whereas technical ability has been described as the 'skill in applying knowledge to specific problems'.<sup>73</sup> Rhoades-Catanach considers how using a business entities

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<sup>65</sup> Lin Mei Tan and John Veal, 'Tax Knowledge for Undergraduate Accounting Majors: Conceptual v Technical' (2005) 3(1) *eJournal of Tax Research* 28.

<sup>66</sup> Bernadette Smith and Sonia Shimeld, 'Drawing Accounting Students into Tax' (Paper presented at the 17th Annual Australasian Tax Teachers' Conference, Victoria University, Wellington, 26–28 January 2005).

<sup>67</sup> Tom Delany, 'A Comparison of the Performance of Taxation Law Students Studying by Different Delivery Modes' (Paper presented at the 8th Annual Australasian Tax Teachers' Association Conference, Queensland University of Technology, Brisbane, 18–20 January 1996).

<sup>68</sup> UNESCO, US National Commission on Libraries and Information Science, *Goals, objectives and participant responsibilities. Meeting of experts on information literacy* (US National Commission on Libraries and Information Science, 2002) <<http://www.nclis.gov/libinter/infolitconf&meet/goals-objectives-participant-responsibilities.html>>; Alan Bundy (ed), *Australian and New Zealand Information Literacy Framework: Principles, standards and practice* (Adelaide, Australian and New Zealand Institute for Information Literacy, 2004).

<sup>69</sup> Christine Bruce, *Information Literacy as a Catalyst for Educational Change: A Background Paper* (UNESCO, the U.S. National Commission on Libraries and Information Science, and the National Forum on Information Literacy, Prague, 2002) 1, <[http://www.infolit.org/International\\_Conference/papers/bruce\\_fullpaper.pdf](http://www.infolit.org/International_Conference/papers/bruce_fullpaper.pdf)>; Bundy, above n 68.

<sup>70</sup> Bruce, above n 69, 1.

<sup>71</sup> Brett Freudenberg, 'Learning to Learn: Business professionals' perceptions of information literacy' (2008) April *ConTax Student e-Newsletter*, Taxation Institute of Australia <[http://www.taxinstitute.com.au/images/contax/ConTax\\_Apr08\\_Feature\\_Article.pdf](http://www.taxinstitute.com.au/images/contax/ConTax_Apr08_Feature_Article.pdf)>.

<sup>72</sup> Audrey Sharp and Kalmen Datt, 'Proposals for Assessment in Tax Teaching' (2010) 4(1) *Journal of Australasian Tax Teachers' Association* 46.

<sup>73</sup> Tan and Veal, above n 65, 33–34.

approach influenced students' learning of tax.<sup>74</sup> Field has used experiential learning to use case studies to develop students' skills in providing tax advice.<sup>75</sup>

Another basis for research could be students' self-efficacy. Bandura describes self-efficacy as individuals' beliefs, thoughts, and feelings about their personal capabilities that affect how they exercise control over their own level of functioning and, in turn, their performance.<sup>76</sup> Understanding self-efficacy is important, as perceptions of self-efficacy can be the determinant of an individual's behaviour in a given situation. Previous studies indicate that self-efficacy is a significant determinant of behaviours such as achievement strivings, academic persistence, and choice of career opportunities, and career competency.<sup>77</sup> More specifically, individual self-efficacy has been found to be positively related to individual performance and satisfaction.<sup>78</sup> It is possible for academics to implement strategies to improve students' self-efficacy, as this can be developed through learning, experience, and feedback.<sup>79</sup> Generally it is contended that the following four categories of experiences lead to the development of self-efficacy: mastery experiences, modelling, social persuasion, and judgements of own physiological states.<sup>80</sup>

A number of research projects demonstrate that, for business students, interacting with industry and having greater understanding of the profession they about to enter can improve students' self-efficacy.<sup>81</sup>

Work integrated learning ('WIL') is also a potential avenue for research, as it is seen that WIL can equip students with the necessary generic skills by offering a 'rich, active and contextualised learning experience'.<sup>82</sup> WIL programs are typically described as 'educational programs which combine and integrate learning and its workplace

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<sup>74</sup> Shelley Rhoades-Catanach, 'Introductory taxation: A business entities approach' (2000) 71(1) *Pennsylvania CPA Journal* 12.

<sup>75</sup> Heather Field, 'Experiential learning in a lecture class: Exposing students to the skill of giving useful tax advice' (2012) 9(1) *Pittsburgh Tax Review* 1, 1-53.

<sup>76</sup> Rhoades-Catanach, above n 74.

<sup>77</sup> Albert Bandura, 'Self-efficacy mechanism in human agency' (1982) 37(2) *American Psychologist* 122.

<sup>78</sup> Marilyn Gist and Terence Mitchell, 'Self-efficacy: A theoretical analysis of its determinants and malleability' (1992) 17 *Academy of Management Review* 183.

<sup>79</sup> Ibid.

<sup>80</sup> Albert Bandura, 'Self-efficacy mechanism in human agency' (1982) 37(2) *American Psychologist* 122; Robert Wood and Albert Bandura, 'Social cognitive theory of organizational management' (1989) 14(3) *Academy of Management Review* 361.

<sup>81</sup> Nava Subramaniam and Brett Freudenberg, 'Preparing accounting students for success in the professional environment: enhancing self-efficacy through a work integrated learning program' (2007) 8(1) *Asia-Pacific Journal of Cooperative Education* 77; Brett Freudenberg, Mark Brimble, Victoria Vyvyan and David Corby, 'A penny for your thoughts: Can participation in a Student-Industry conference improve students' presentation self-efficacy and more?' (2008) 15(5) *The International Journal of Learning* 188; Brett Freudenberg, Mark Brimble and Craig Cameron, 'Where there is a WIL there is a way' (2010) 29(5) *Higher Education Research & Development* 575.

<sup>82</sup> Belinda McLennan, 'Work-integrated learning (WIL) in Australian universities: The challenges of mainstreaming WIL' (Paper presented at the Proceedings of the Career Development Learning - Maximising the Contribution of Work Integrated Learning to the Student Experience NAGCAS Symposium, Melbourne, 2008) <<http://tls.vu.edu.au/vucollege/LiWC/resources/NAGCASpaper-final10June08.pdf>>.

application, regardless of whether this integration occurs in industry or whether it is real or simulated'.<sup>83</sup>

Research on WIL programs has demonstrated increases in student job knowledge and skills, improved attitudes and behaviours towards work readiness,<sup>84</sup> substantial personal development by students<sup>85</sup> and the development of generic skills.<sup>86</sup> An example of WIL is 'service learning', which has been used by Blissenden to improve learning outcomes for tax students engaged with providing free tax return preparation advice.<sup>87</sup>

The top two characteristics of a survey of 208 effective Australian lecturers were linking theory to practice and *motivating student interest*.<sup>88</sup> Student motivation is important: Sheull argues that 'what the student does is actually more important in determining what is learnt than what the teacher does'.<sup>89</sup> Consequently, research into students' motivation towards their studies and how different teaching practices may affect this is an area for consideration. Scott examined a substantial database of open-ended comments made by graduates from 14 Australian universities during the period 2001–2004 about the best aspects of their university course and those aspects most needing improvement. With respect to learning methods, a key finding in Scott's report was that practice-orientated (which included many WIL methods) and interactive, face-to-face learning methods attracted the largest number of 'best aspect' comments.<sup>90</sup> Scott suggests that it is these methods that students identified as most engaging them in productive learning. Review of students' motivation towards tax studies has been the focus of Rodman<sup>91</sup> and Blissenden and Coleman.<sup>92</sup>

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<sup>83</sup> Mary Atchison, Sarah Pollock, Ern Reeders and Janine Rizzetti, *Work-integrated learning paper* (Melbourne: RMIT University, 2002) 3.

<sup>84</sup> Katherin Hughes and David Moore, *Pedagogical strategies for work-based learning*, IEE Working Paper No. 12 (New York, NY: Columbia Teachers College, 1999).

<sup>85</sup> J Day, MJ Kelly, D Parker and MF Parr, 'The role of industrial training in business studies sandwich degrees' (1982) Summer *Business Education* 105.

<sup>86</sup> Carol-Joy Patrick and Gay Crebert, 'The contribution of work placement to generic skills development' in *Proceedings of the 15th Annual AAEE Conference* (pp. 40–46). Toowoomba, Australia: AAEE (2004); Brett Freudenberg, Mark Brimble, Craig Cameron and Dianne English, 'Professionalising Accounting Education – The WIL Experience' (2011) 45(1) *Journal of Cooperative Education and Internships* 80.

<sup>87</sup> Michael Blissenden, 'Service Learning: An example of experiential education in the area of taxation law' (2006) 16(1) *Legal Education Review* 183.

<sup>88</sup> Ballantyne, Bain and Packer, above n 49.

<sup>89</sup> Thomas Sheull, 'Cognitive conceptions of learning' (1986) 56(4) *Review of Educational Research* 411, 429.

<sup>90</sup> Geoff Scott, *Accessing the student voice: Using CEQuery to identify what retains students and promotes engagement in productive learning in Australian higher education* (2005), ix, <[http://www.uws.edu.au/data/assets/pdf\\_file/0010/63955/HEIPCEQueryFinal\\_v2\\_1st\\_Feb\\_06.pdf](http://www.uws.edu.au/data/assets/pdf_file/0010/63955/HEIPCEQueryFinal_v2_1st_Feb_06.pdf)>.

<sup>91</sup> Sandra Rodman, 'What Motivates a Taxation Law Student? (How do I get them to love tax?)' (Paper presented at the 8th Annual Australasian Tax Teachers' Association Conference, Queensland University of Technology, Brisbane, 18–20 January 1996).

<sup>92</sup> Michael Blissenden and Cynthia Coleman, 'Motivating Accounting and Law Students to Embrace the Study of Taxation' (Paper presented at the 17th Annual Australasian Tax Teachers' Conference, Victoria University, Wellington, 26–28 January 2005).

'Graduate attributes', rather than the graduate's specific degree, has been described as an important determinant of graduate success in the workplace.<sup>93</sup> Graduate skills demanded by employers include being confident communicators, team players, critical thinkers, problem solvers, and having initiative.<sup>94</sup>

A study by Kavanagh and Drennen examined the perceptions of employers and students in accounting of the importance of various graduate skills and attributes.<sup>95</sup> They found that while employers still expect a base level of technical skills, they require 'business awareness' and an understanding of the 'real world'. In fact, these two items were within the top three skills that employers are expecting graduates entering the accounting profession to have.<sup>96</sup> However, students did not know — or misunderstood — employers' expectations, as 'business awareness' was not mentioned by students at all.<sup>97</sup> Consequently there is a 'gap' between students' generic skills and employers' expectations; therefore anything that academics can do to address this gap could be beneficial. A useful tool in measuring students' generic capabilities, and whether learning and teaching practices may have influenced these, has been developed by Lizzo and Wilson.<sup>98</sup> Schwartz and Stout have considered what the differences were between tax advisors and tax educators about the educational requirements of undergraduates to formulate recommendations.<sup>99</sup>

## V DIFFERENT METHODOLOGIES TO UNDERTAKE SoLT

When undertaking SoLT, as with any other research project, it is essential to have a clear plan about what is being done and what metrics will be measured. With this in mind, the appropriate methodological approach can be adopted. It is important to consider this early in the project, preferably prior to implementation. All too often academics may try to engage in SoLT after the implementation of an innovation and try to retro-fit what they have done. Glassick and others provide a useful set of six steps when considering the SoLT:

- **Clear goals:** Does the scholar state the basic purpose of his or her work clearly? Does the scholar define objectives that are realistic and achievable? Does the scholar identify important questions in the field?
- **Adequate preparation:** Does the scholar show an understanding of existing scholarship in the field? Does the scholar bring the necessary skills to her or his

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<sup>93</sup> Lee Harvey, 'New realities: The relationship between higher education and employment' in *European Association of Institutional Research Forum* (Lund, Sweden: University of Central England in Birmingham, 1999)

<sup>94</sup> Lee Harvey, Sue Moon and Vicki Geall, *Graduates' work: Organisational change and students' attributes* (Centre for Research into Quality, 1997), <<http://www.uce.ac.uk/crq/publications/gw/gwcon.htsn>>.

<sup>95</sup> Marie Kavanagh and Lyndal Drennan, 'What skills and attributes does an accounting graduate need? Evidence from student perceptions and employer expectations' (2008) 48 *Accounting and Finance* 279.

<sup>96</sup> *Ibid*, 295–296.

<sup>97</sup> *Ibid*, 294.

<sup>98</sup> Alf Lizzio and Keitha Wilson, 'First-year students' perceptions of capability' (2004) 29(1) *Studies in Higher Education* 109.

<sup>99</sup> Bill Schwartz and David Stout, 'A Comparison of Practitioner and Educator Opinions on Tax Education Requirements for Undergraduate Accounting Majors' (1987) *Issues in Accounting Education* 112.

work? Does the scholar bring together resources necessary to move the project forward?

- **Appropriate methods:** Does the scholar use methods appropriate to the goals? Does the scholar apply effectively the methods selected? Does the scholar modify procedures in response to changing circumstances?
- **Significant results:** Does the scholar achieve the goals? Does the scholar's work add consequently to the field? Does the scholar's work open additional areas for further exploration?
- **Effective presentation:** Does the scholar use a suitable style and effective organisation to present his or her work? Does the scholar use appropriate forums for communicating work to its intended audiences? Does the scholar present her or his message with clarity and integrity?
- **Reflective Critique:** Does the scholar critically evaluate his or her own work? Does the scholar bring an appropriate breadth of evidence to her or his critique? Does the scholar use evaluation to improve the quality of future work?"<sup>100</sup>

A useful guide providing discourse about the meaning of SoLT, some examples, and further resources, can be found in the Carnegie material that has been compiled.<sup>101</sup> Additionally, the International Society for the Scholarship of Teaching and Learning has good resources.<sup>102</sup>

One method that may be adopted to conduct SoLT is that of a case study. While case studies may seem rudimentary, Shulman points out their similarities to those used in medical research:

She worked with teachers to become scholars of their own practice, to document their work and to write it up in narrative and analytic cases of teaching and learning. As in medicine, these were 'problem' or 'dilemma' driven cases, constructed around unexpected difficulties that the teachers had encountered, coped with, analysed, reflected upon, and were now prepared to share.<sup>103</sup>

Case studies can also provide/be an initial step into a larger project:

Many begin modest projects of inquiry in their own classrooms, aimed at providing evidence to inform a next stage of instructional design. However, this effort can lead to more ambitious questions aimed at identifying common roadblocks to learning, pushing the limits of one's own disciplinary styles of inquiry, and adopting a variety of methods.<sup>104</sup>

A potential problem with case studies is that they may involve only a very small sample. However, it is still possible that these may be publishable if they are approached in a thorough way, they address a gap in the literature, and they are justified as a first step.

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<sup>100</sup> Charles Glassick, Mary Huber, and Gene Maeroff, *Scholarship assessed: Evaluation of the professoriate* (The Carnegie Foundation for the Advancement of Teaching, San Francisco, 1997) 36.

<sup>101</sup> Hutchings, Babb and Bjork, above n 46.

<sup>102</sup> International Society for the Scholarship of Teaching and Learning, *SOTL Resources* (2011), <<http://www.issotl.org/sotl.html>>.

<sup>103</sup> Shulman, above n 44, vi.

<sup>104</sup> Hutchings, Huber and Ciccone, above n 12, 11.

The limitations should specify how the study could be extended in the future. In the author's experience, it can be difficult to have case studies published in refereed journals when there are less than 10 participants: it is preferable to have at least 30.

In terms of what evidence is going to be used to exemplify learning outcomes, caution needs to be exercised. For example, caution is needed when using 'improvement in grades' as evidence of improved learning outcome for students, as reviewers may be sceptical about whether improved grades are more reflective of easier assessment, easier marking, or something else. For SoLT to have credibility, academics need to demonstrate some objective measure or control.

One way to get data is through the use of student evaluations of teaching ('SET') or of courses ('SEC') that ask poignant questions addressing particular learning or teaching outcomes. The use of a developed survey instrument could be warranted, although careful consideration of the measures and questions needs to occur. It is worthwhile considering a longitudinal study with pre-intervention and then post-intervention surveys. Such a study could include relevant demographic information such as gender, prior work experience, age, and first-in family to attend university, as these may influence the impact of the teaching strategy. Also, it is worthwhile considering if it is possible to have as a comparison a control group or similar cohort of students who have not undergone the intervention, such as a survey of students at a different campus of the same university or one at another university. The greater the similarity in the cohorts, the less chance for confounding factors.

Interviews can be useful to supplement and support quantitative data and to explore themes. It is important that such interviews are placed into the context of the literature. One useful way of displaying qualitative information is through the use of a table with selected quotes used to back up points or to provide a framework of analysis.<sup>105</sup>

Needless to say, given that this is a research project the relevant ethics approval should be sought and obtained. This can be a useful process to help ascertain and clarify how the project will proceed. Academics should consider issues such as confidentiality and assurance that the research will not affect student grading.

## VI DISSEMINATING SoLT

A critical difference between 'Scholarship **in** Learning' and 'Scholarship **of** Learning' is the concept of disseminating the findings to peers. It is important that academics undertake this task, as sometimes exhaustion can follow the implementation of a learning/teaching intervention. Dissemination could be through learning and teaching arenas or in a specific discipline: each has its own advantages and disadvantages. It is preferable to have an idea of how to disseminate at the beginning of the project, as this helps to frame what is going to occur and the approach to the research. One of the most useful things is to locate the most 'appropriate journal and/or conference' in which to

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<sup>105</sup> See for example: Brett Freudenberg, Mark Brimble and Victoria Vyvyan, 'The Penny Drops: Can Work Integrated Learning Improve Students' Learning?' (2010) 4(1) *eJournal of Business Education & Scholarship of Teaching* 42, 50, 56.

publish the work.<sup>106</sup> This is important: as journals may have preferences for different research styles and strategies, this can affect the methodology adopted as well as the final presentation of results. Pragmatically, this may also mean that your literature review 'should include papers from the journal or conference you are targeting'.<sup>107</sup> While some question the ethics of this,<sup>108</sup> this can be a pragmatic reality. For a comprehensive listing of societies and journals interested in SoLT, see the work of McLeod and others.<sup>109</sup>

At first consider dissemination through conferences and seminars, whether internal to the academic's own institution or external. This can be a useful step as it gives a due date to write up an initial draft paper as well as providing a forum for feedback on how the paper could be improved. However, after the conference it is recommended that publication be pressed through a refereed journal or industry publication.

Another way to get feedback on a draft is posting the draft paper online through the Social Science Research Network ('SSRN'). This is particularly useful as it may lead to journals approaching the academic to submit the finalised version of their work to the journal. Downloads of the draft on SSRN can also give confidence to the academic that there is interest in their endeavours, which can help to encourage finalisation of the piece.

McKinney has collated a practical guide in terms of tips and processes that academics should follow in getting published.<sup>110</sup> Depending upon the precise methodology adopted, the basic format for a SoLT piece should be: Introduction; Theory, including relevant broad literature; Research Method; Descriptive Statistics; Results; Discussion; Limitations/Further research; and Conclusion.

## VII LEVERAGING SOLT

While Trigwell and Shale indicate that the primary aim of SoLT should be the enhancement of students' learning,<sup>111</sup> there are a number of other benefits that academics can leverage off to improve their own experience and their career. Given the modern university environment, with its focus on KPIs, the observation of Huber is pertinent when it comes to SoLT:

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<sup>106</sup> Sharynne McLeod, Marian Tulloch, Leonora Ritter and Jenny Kent, *Publishing scholarship in teaching and learning* (Charles Sturt University, 2009) 1, <[www.csu.edu.au/division/landt/reschol/documents/publishinginL&T.doc](http://www.csu.edu.au/division/landt/reschol/documents/publishinginL&T.doc)>.

<sup>107</sup> Ibid.

<sup>108</sup> Gurm, above n 28.

<sup>109</sup> McLeod, Tulloch, Ritter and Kent, above n 106.

<sup>110</sup> Kathleen McKinney, *Getting SoTL Articles Published - a Few Tips* (Illinois State, 2011) <<http://sotl.illinoisstate.edu/resLinks/sotlMats/getPub.shtml>>.

<sup>111</sup> Keith Trigwell and Suzanne Shale, 'Student learning and the scholarship of university teaching' (2004) 29(4) *Studies in Higher Education* 523.

You're looking for papers published in peer-reviewed, high-profile journals; you're looking for funding brought in from competitive sources ...; you're looking for speaking invitations; you're looking for adoption or adaptation of the work in other people's programs.<sup>112</sup>

Academics need to frame their SoLT into these criteria to ensure that due recognition is given and acknowledgement received for their efforts and expertise. It is argued that the SoLT can be utilised by an academic to advance their own career. It has been stated that a critical aspect of SoLT is to improve the recognition and importance of learning and teaching, which can be seen as 'poor second cousin' in the academic arena. Indeed, SoLT is seen as 'upping the ante with respect to teaching'.<sup>113</sup>

Other potential benefits of SoLT include renewing one's own enthusiasm towards teaching, and improving policies and rewards.<sup>114</sup> Also, students who participate can have additional benefits such as gaining insights to their — and others' — learning experiences and developing insight into the practice of professionals.<sup>115</sup> SoLT can also lay the foundation for 'best practice' and for being able to influence others in your discipline. The importance for academics to become familiar with and engage in SoLT is reflected by the growing trend of institutions to include SoLT in their strategic plans, teaching awards, and promotion policies; however caution is expressed as to the sincerity of this and whether it is just 'rhetoric'.<sup>116</sup>

Furthermore, the SoLT can be another source of (potentially more reliable and valuable) data to supplement SETs and SECs. This is particularly important, as SETs are been highly criticised, with inferences that these can be manipulated with a few jokes to entertain, the availability of solutions to make life easier;<sup>117</sup> or even collusion between students and academics.<sup>118</sup>

SoLT is a pragmatic way to get recognition for innovations done, as universities focus on external validation of academics' work. So if the SoLT gets published, presented, influences others, or gets awards, then this helps academics with their career. Too often bright academics approach their work without being strategic. Also, SoLT can have personal benefits for the academics involved: the opportunities it presents to academics to discuss and share their teaching (and scholarship/research into) with colleagues appear to meet 'a deeply felt need'.<sup>119</sup> In the process of obtaining grants for teaching and learning innovations, the use of SoLT will help to frame a strong grant application, as well as to ensure that it is well positioned within the current literature. In the interest of

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<sup>112</sup> Huber, above n 38, 27.

<sup>113</sup> Robert Menges and Maryellen Weimer, *Teaching on solid ground: Using scholarship to improve teaching* (San Francisco, CA: Jossey Bass, 1996) xii.

<sup>114</sup> Tony Ciccone, 'Examining the impact of SoTL' (2008) 3(1) *The International Commons* 12.

<sup>115</sup> Haigh, above n 29, 4.

<sup>116</sup> Neil Haigh, Peter Gossman, and Xiaomin Jiao, 'Undertaking an institutional 'stock-take' on SoTL: New Zealand university case studies' (2010) 30(1) *Higher Education Research and Development* 9.

<sup>117</sup> Kim Sawyer, Jackie Johnson and Mark Holub, *Decline in Academe* (2007) 20, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=961993](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=961993)>.

<sup>118</sup> Calin Valsan and Robert Sproule, 'The Invisible Hands behind the Student Evaluation of Teaching: The Rise of the New Managerial Elite in the Governance of Higher Education' (2008) *XLII* (4) *Journal of Economic Issues* 939, 940.

<sup>119</sup> Hutchings, Babb and Bjork, above n 46, 3.



getting most value from a grant, grant committee can be interested in how the outcomes will be disseminated to the wider academic audience. Consequently, applicants can benefit from having a history of SoLT. Furthermore, engagement with SoLT can help to influence professional bodies with respect to, or regarding how, they could undertake strategies to improve the educational outcomes for those within the discipline.

It has been highlighted that while the SoLT may 'accompany or engender teaching excellence',<sup>120</sup> it is not necessarily synonymous with this. However, the engagement with SoLT can provide important evidence to support teaching award applications, while the critical reflection involved with SoLT can be an important attribute that award committees are looking for.

Additionally, SoLT can be used by academics in their annual staff reviews to reveal what research and reflection they have undertaken to try to improve student learning in their courses. Indeed, several Australian universities use the SoLT as part of their promotion criteria in assessing staff.<sup>121</sup> This is particularly important for those academics making a case for promotion for outstanding contribution to teaching excellence.

Research demonstrates that good teaching is related to student satisfaction with their degree program;<sup>122</sup> as Trigwell and Shale state, the aim of SoLT should be the enhancement of students' learning.<sup>123</sup> While not all SoLT will extend beyond a conference presentation to refereed publications, the insight provided and the analysis of a SoLT project can have profound implications for an academic's teaching practices, and thus for student learning. For example, a pilot study in which the author was involved, about how professionals learn in terms of information literacy, could not get published in a refereed journal as the study was considered too small. Although it was published through a professional body's electronic student newsletter and on-line through SSRN,<sup>124</sup> the biggest benefit for the author from the study was that it made him critically reflect on what exactly he was trying to teach in his tax courses. In particular, what was the core framework knowledge that students needed so they could build upon this through information literacy? This led to a number of changes in the author's teaching, including the use of concept diagrams to explain complex structures or provisions, and the need to explain 'core concepts' before moving on to more complex ideas. These new teaching practices have led to improved SETs and SECs and to more satisfied students, which then have led to teaching award recognition at both institutional and national level.

## VIII CONCLUSION

SoLT is an important attribute for modern academics to engage and participate in. It can give academics (and their institutions) creditability. To have academic 'integrity', academics cannot just be experts in their discipline area: they need to be actively

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<sup>120</sup> Ibid.

<sup>121</sup> Trigwell, Martin, Benjamin and Prossner, above n 10, 156.

<sup>122</sup> Alf Lizzio, *Facilitating Student Engagement: Climbing the Staircase or bust!* (Griffith University, 2010).

<sup>123</sup> Trigwell and Shale, above 111.

<sup>124</sup> Freudenberg, above n 71.

engaged in how they can effectively disseminate this expertise to their students.<sup>125</sup> The SoLT is more aligned with Romanville's view about the role of universities being the creation and dissemination of knowledge.<sup>126</sup> The SoLT can be seen as an integration of these two aspects of this role, providing a foundation to create knowledge about teaching and learning practices, and then to disseminate this for the benefit of all stakeholders.

While the corporatisation of universities appears to be here for the long term, it is important that managers are provided with accurate information to assess academics' performances, as KPIs are only as good as the data they are based on. SoLT offers academics a mechanism for the provision of more meaningful information about what is occurring in their classrooms. It is also something that academics can use to support their endeavours and further their careers, as more academics will be asked to provide evidence of their students' learning outcomes. However, it is critical that SoLT is well researched and framed. This includes being familiar with the broader pedagogical theory of learning and teaching, using appropriate research methods to investigate outcomes, and then considering the broader implications beyond the discipline. Most importantly, the engagement with SoLT can be used to improve student learning, which is critical given the challenges faced in the sector. Indeed, academics' engagement with SoLT is central to the notion of what makes a university education:

If teaching does not involve research, then it is not, ipso facto, university teaching.<sup>127</sup>

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<sup>125</sup> Shulman, above n 44, vii.

<sup>126</sup> Romainville, above n 40.

<sup>127</sup> Coaldrake and Stedman, above n 3, 19.