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FOREWORD

The papers included in this edition of the *Journal of the Australasian Tax Teachers Association* (JATTA) were presented at the 28th Annual Conference of the Australasian Tax Teachers Association (ATTA). The ATTA conference was held from 20 to 22 January 2016 and hosted by the School of Taxation & Business Law, UNSW Business School.

The theme of the conference was 'Tax and Time Travel: Looking Backwards and Looking Forwards'. Many of the papers at the conference and in JATTA 2016 focused on this theme, but some also dealt with other important issues relating to tax policy, tax design and tax administration. We hope that the papers published here will make a significant contribution to the literature on the diverse range of topics they deal with.

Plenary presentations and dinner speeches at the ATTA conference were given by Professor Diane Ring, Boston College Law School; Greg Smith, Chairman of the Commonwealth Grants Commission; Jan Farrell, former Deputy Commissioner of the Australian Taxation Office (ATO); Andrew Mills, Second Commissioner of the ATO; The Honourable Justice William Young KNZM, Judge of the Supreme Court of New Zealand; Ross Gittins, Economics Editor of *The Sydney Morning Herald*; and the Patron of ATTA, Professor Gordon Cooper.

We would like to thank Editor-in-Chief, Professor Dale Pinto and ATTA President, Professor Adrian Sawyer for their guidance and support. Thank you also to all authors that submitted an article to JATTA 2016. We also thank the reviewers of articles for their contribution. We would especially like to thank two reviewers (who unfortunately must remain anonymous) for 'coming to the rescue' at short notice and providing invaluable feedback that contributed to JATTA 2016. Finally, a big thank you goes to Trischa Mann for her dedication to the copyediting task for JATTA 2016. She has now worked on JATTA since 2014.

Dale Boccabella and Ann Kayis-Kumar
School of Taxation & Business Law, UNSW
15 December 2016

SOME COMMENTS ON THE ROLE OF A REVIEWER (REFEREE) OF AN ARTICLE

Inspired by others, I briefly set out my thoughts or suggestions on how a reviewer (referee) could approach the task of reviewing an article for a peer-reviewed tax journal – or any journal. These comments may help those who have not reviewed many articles, and it may help practitioner reviewers as well. The comments are also designed to get us, as a scholarly community, thinking about this issue and other issues related to the peer review process. The comments cannot be taken to be exhaustive.*

The role of the reviewer is very important in the ‘machine’ that is the publication of peer-reviewed articles. To be asked to review an article by an editor is an honour. It usually reflects the attainment of some standing or knowledge in a disciplinary area, and is a concrete indication that the editor is putting some faith or trust in the person to assist with the editor’s all-important question of ‘to publish’ or ‘not to publish’. Obviously, this is very important to the author of the article, but also the journal itself.

From editors’ extensive knowledge, they will usually have a reasonable idea of the suitability of a particular person for a reviewing task. However, editors cannot always know how well equipped a potential reviewer is to review an article. Accordingly, it is incumbent on reviewers, when approached, to ask themselves whether they can effectively review an article. In this regard, I suggest to both a reviewer and editors, as part of the ‘sounding out process’, that the person approached to be a reviewer be given 4–6 days to ‘scan read’ the article, and from that reading, make a judgment as to whether he/she can effectively review the article. This process should give editors more confidence in the reviewer, and it can also allow for better planning for the journal. If the person approached cannot review the article, the editor can move onto another potential reviewer quickly, and not face the risk of discovering ‘an unsuitable reviewer’ 6–7 weeks later (when a first read may be made).

All journals for which I have reviewed articles (mostly tax journals) work on the basis that the reviewer does not know who the author is, and the author does not know who the reviewer is; some call this double-blind reviewing. When reading an article, reviewers may be tempted to give some thought to the identity of the author. For me, you must try very hard *not* to focus on author identification; your focus should be on the piece of work. If you are convinced you know who the author is, you have an obligation to let the editor know, so the editor can make a judgment about what to do. Presumably the editor will want to be convinced that you can approach the task in a strictly objective manner. (I once inadvertently established the author’s identity, but the editor decided to keep me on).

On the decision to review or not, it is true that there is currently no direct financial reward for reviewing an article. And, from what I can gather, my university (and I suspect others in Australia) does not attach any particular significance to being a reviewer. That said, many institutions will consider reviewing as an important service item, and in New Zealand it would be valuable to include in a Performance-Based Research Fund evidence portfolio.

Accepting for a minute that low importance is attached to reviewing, you may ask, why should I bother? In short, it is a service to your discipline, and if every academic said no to reviewing, ultimately, your discipline as a whole, as well as the journal, may suffer. Perhaps you and your disciplinary colleagues may suffer. In any event, the ‘no benefit’ assertion is

* For further comments on the role of a reviewer (and other comments concerning ‘getting published’), see AJ Sawyer, ‘Demystifying the Challenges Involved in Publishing a High Quality Taxation Paper’ (2014) 27(1) *Accounting Research Journal* 7.

questionable, given that reviewing an article can be a very good learning experience if done properly. It forces you to think about the structure of an article, topic coverage, originality, contribution, and the like – all things that are at the core of an academic's everyday work. In addition, being a reviewer often means you are the first person exposed to new research in your discipline.

It is reasonable to accept only one or two reviews per year, although senior academics with specialist expertise in an area may be expected to do more. If you are doing more than this, it suggests that some may not be carrying their fair share of the load for the discipline.

Assuming the person accepts the request, asking an editor for 5–6 weeks to review an article is appropriate. It is best to meet the deadline commitment made, but if it becomes apparent the reviewer will be late, the reviewer has an obligation to keep the editor informed. In my experience (I am nearly always a week or so late), editors appreciate being kept informed, especially if it allows the editor to keep the author informed. It should not have to be said that a reviewer who needs to withdraw should tell the editor as soon as possible that he or she is not going to carry out the review, after first stating they would.

As to the task of reviewing, this would require an article in itself, and there is a growing body of guidance out there. Yet, academics (most frequent reviewers) rarely get any formal guidance or training on this. Further, editors of journals do not systematically give reviewers feedback on their reviews. There are times, however, when authors acknowledge reviewers for their helpful comments.

I make the following observations. First, you have to take the reviewing task seriously. If you plan to allocate 2 hours to the task, you are not serious; tell the editor that you cannot do the review. (An editor who is told: 'I will look at this on the plane flight between Melbourne and Sydney', should drop this reviewer, probably for good, if this is to be the sum total of their review effort.)

Second, there is no magical approach or one best approach to reviewing. This is what I normally do. I do a first read of the article, and here I am mainly focused on gaining understanding or comprehension. I make notes, queries, etc., on the paper as I am reading, mainly to ensure understanding. Depending on the complexity of the area, it can take some time to gain sufficient understanding.

I will then let it sit for 2–4 days before coming back to it. At this second stage, I will confirm my understanding, but I will now also be looking for the usual features of a good piece of writing or research. Briefly, they are: (1) Does the article raise and identify a problem or an issue of some significance, and thereby set out a clear motivation? (2) Has the issue been dealt with elsewhere? (3) Does the article deal with the problem comprehensively and at a sufficient level of depth, or does the article do what it claims it will do? (4) Has the author considered previous contributions to the problem? (5) Is the content well-ordered? and (6) Does the introduction give the reader a clear sense of the direction the article is taking?

The issue of reviewer disposition is interesting. Some reviewers will come to the task with a 'rejection' mindset. That is, they are on the lookout for anything that gives them a basis for saying the article is not good. Others have what has been called a 'developmental' approach to reviewing. These reviewers are looking to see how they can help the author improve the article, even if they recommend rejection for the present journal. I would encourage you to follow the developmental reviewing approach.

Finally, it is implicit in what I have just said that there is no room in feedback to authors for 'personal' remarks, or remarks that are generalised beyond the scope of the content of the article. Accordingly, and consistent with developmental reviewing, couch your comments to authors in a positive light, wherever possible.

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15 December 2016

THE EVOLUTION OF THE APPROACH OF THE NEW ZEALAND COURTS TO TAX AVOIDANCE

Paper accompanying plenary address delivered at ATTA 2016

THE HON JUSTICE WILLIAM YOUNG KNZM*

I GENERAL ANTI-AVOIDANCE PROVISIONS IN NEW ZEALAND

Although there have been anti-avoidance provisions in New Zealand tax legislation since 1878,¹ they were not seriously invoked by the Commissioner until the 1960s.² At this time, s 108 of the *Land and Income Tax Act 1954* was in force. It provided:

Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

This language was very similar to that used in s 260 of the *Income Tax and Social Services Contribution Assessment Act 1936–1950* (Cth) of Australia (the Australian Act)³ and the New Zealand courts (including the Privy Council) saw the two sections as having the same meaning. This meant that the Privy Council decision in *Newton v Federal Commissioner of Taxation*,⁴ a case concerned with s 260, was applicable to s 108.⁵

In response to judicial criticism,⁶ s 108 was amended in 1974 and, as amended, was re-enacted as s 99 of the *Income Tax Act 1976* (NZ). The 1976 Act was replaced by the *Income Tax Act 1994*, which in turn was replaced by the *Income Tax Act 2007*. In that Act, s BG 1 is the general anti-avoidance provision. I am going to say a little about the background to s 99 of the 1976 Act and, in doing so, will discuss briefly the principal respects in which it differed from s 108 of the 1954 Act. One of these which I should mention now is that the 1974 amendment, and thus s 99 of the 1976 Act, provided for a power of reconstruction, the absence of which had earlier sometimes resulted in tax-avoiding taxpayers succeeding against the Commissioner. Generally, however, I do not propose to devote attention to the shifts in language between the original s 108 and the current s BG 1. When discussing cases

* Judge of the Supreme Court of New Zealand.

¹ The legislative history is explained in *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 at 594–5 (PC).

² The only earlier case is *Timaru Herald Co Ltd v Commissioner of Taxes* [1938] NZLR 978 (CA), where the Commissioner lost in the Court of Appeal on (among other things) an argument as to the application of s 170 of the *Land and Income Tax Act 1923*.

³ The shared legislative history of the two provisions is set out in *Mangin*, above n 1, at 594–5 and 598.

⁴ *Newton v Federal Commissioner of Taxation* [1958] AC 450 (PC).

⁵ See Part IV below, text near footnote 23.

⁶ See, for instance, the dissenting judgment of Lord Wilberforce quoted in Part V.

I will identify the particular provision⁷ in issue, and when addressing the sections more generally, I will refer to them collectively as the GAAR (general anti-avoidance rule).

II AN OVERVIEW

In a number of the early cases, the difficulty of giving practical and principled effect to the GAAR in the context of the tax system as a whole encouraged counsel to advance arguments which, if accepted, would have deprived the GAAR of substantial effect. It was thus argued that:

- (a) It caught only transactions which were shams (the 'applicable only to shams argument').
- (b) It applied only between the parties to transactions, had no fiscal effect and, therefore, could not be relied on by the Commissioner (the 'no fiscal effect argument').
- (c) It affected only tax liabilities which had accrued at the time of the arrangement (the 'accrued liabilities only argument').

The rejection of these arguments meant that the courts were required to address directly the potential tension between the GAAR and the provision or provisions relied on by the taxpayer.

The scope for tension was substantially reduced by the exclusion for ordinary business or family dealings adopted in *Newton*.⁸ This exclusion meant that the GAAR would not apply to situations where tax consequences are the inevitable consequence of a straight-forward 'ordinary' transaction, such as, for instance, the 'clean' transfer of an income producing asset from one person to another. On this basis, many, and perhaps most, of the hypothetical examples often postulated to establish the impracticality of a GAAR can be brushed aside. The ordinary business or family dealing exclusion thus operated as a sensible filter on the operation of the GAAR. But in relation to cases not filtered out, it did not provide a comprehensive or principled mechanism for determining whether the GAAR should prevail over the tax provision relied on by the taxpayer. In such a case, there thus remained scope for tension between the GAAR and the tax provision relied on by the taxpayer.

If the resolution of this tension were approached as involving orthodox statutory interpretation principles, the answer might be thought to depend on one, other or both of:

- (a) application of the *maxim generalia specialibus non derogant*⁹ as between the GAAR and the tax provision relied on; or
- (b) scheme and purpose analysis as to whether the GAAR or that provision prevailed.

Neither approach, however, provides a sure route to a principled and predictable outcome. When tax avoidance is in issue, the question whether the GAAR or other provision should prevail is always particular to the facts of the case at hand and, at least to my way of thinking, thus involves application as much as interpretation. In such cases it is almost always open to

⁷ Albeit slightly loosely. I will refer to s 108 of the 1954 Act, s 99 of the 1976 Act (which I will treat as encompassing s 108 as amended in 1974) and s BG1 of the 2007 Act (which I will treat as encompassing the equivalent provisions in the 1994 Act).

⁸ *Newton*, above n 4.

⁹ 'General things do not derogate from specific things': Bryan A Garner (ed) *Black's Law Dictionary* (9th ed, St Paul (MN), 2009) at 752.

question whether it is the GAAR or other tax provision which is the particular provision (and which, in accordance with the maxim, should prevail). As well, with the rejection of these two arguments, the basic premise of the GAAR is that it applies to avoid tax arrangements which, but for the invocation of the GAAR, would be effective. On this basis, an arrangement which is voidable under the GAAR is in a twilight zone; sufficiently within the scheme and purpose of the provision relied on by the taxpayer to be valid unless the GAAR is invoked; but insufficiently so to withstand the application of the GAAR. In such a twilight zone, orthodox scheme and purpose interpretative analysis provides little illumination.

There is scope for debate as to the analysis just offered. The minority judgment in *Ben Nevis Forestry Venture Ltd v Commissioner of Inland Revenue* proceeds on the basis that 'specific statutory allowances under the Income Tax Act are not in potential conflict with the general anti-avoidance provision' and that there is thus no need for 'reconciliation'.¹⁰ That approach appears to be inconsistent with the twilight zone I have postulated. I set out later in the paper the key passages from that judgment.¹¹ For present purposes, it is sufficient for me to say that I think that my analysis, right or wrong as it may be in terms of principle, is consistent with the drift of the cases, including, significantly, the most recent New Zealand Supreme Court judgments.

Another way of attempting to resolve, or at least mitigate, the tension between the GAAR and other tax provisions is to restrictively interpret the former; that is by limiting it in respects which go beyond the ordinary business or family dealing exclusion. I see this line of approach as exemplified:

- (a) reasonably well, in the cases which suggest that tax avoidance involves the non-incurring of the economic consequences which the legislature envisaged as the correlative of the tax benefit claimed; but
- (b) not so well, in the view that tax avoidance involves the 'crossing of a line' or other very generalised concepts.

A further approach is to see the mischief of tax avoidance as the use of general or particular features of the tax regime to obtain tax advantages of a kind not intended to be conferred by the legislature and to apply the GAAR accordingly. This is the 'parliamentary contemplation' test which the New Zealand Supreme Court has adopted. Where the taxpayer has not incurred the economic consequences envisaged by the legislature as the correlative of the tax benefit claimed, the scheme will fail the parliamentary contemplation test. The parliamentary contemplation test can thus be seen as being largely a generalised reformulation of approach (a) above.

The parliamentary contemplation test has some advantages. As just mentioned, it addresses directly what most see as objectionable with tax avoidance. It enables tax outcomes closely tailored to the facts of the cases at hand. It is consistent with the view that the legislative purpose of the GAAR is to fill in gaps which the legislature may have inadvertently created. As well, and assuming my twilight zone analysis is correct, it also avoids the use of inapt principles of statutory interpretation to resolve a sui generis problem which involves both interpretation and application.

¹⁰ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289, at [2].

¹¹ See final paragraphs in Part XI and, for the minority, final paragraphs in Part XIII.

Orthodox statutory interpretation is concerned with meaning.¹² Although meaning may be determined by reference to legislative purpose,¹³ such purpose is conventionally addressed largely objectively. When interpreting a statute a judge does not inquire as to what the legislature might have enacted if the facts of the case at hand were before it – an exercise which, as I will show, has from time to time been carried out in tax avoidance cases. The parliamentary contemplation test thus looks unorthodox. As well, the bespoke outcomes it produces can be viewed as contrary to the principle that laws should be of general application.

In this paper I discuss the background to the adoption by the Supreme Court of the parliamentary contemplation test. In doing so, I will pick up on some of the ideas just touched on. As well, I will give two examples of the application of the test, one by the High Court and the other by the Court of Appeal.

III MY STARTING POINT – *NEWTON V FEDERAL COMMISSIONER TAXATION*

From the early years of the last century, Australian revenue authorities (Federal and state) relied on anti-avoidance provisions and this gave rise to a number of reported decisions. In contrast, in New Zealand, the GAAR was not seriously invoked by the Commissioner until the 1960s. By this stage, the Privy Council had decided *Newton v Federal Commissioner of Taxation*.¹⁴ So when the New Zealand courts came to grapple with s 108, *Newton* was very much their starting point.

As has been mentioned, *Newton* concerned s 260 of the Australian Act.¹⁵ The companies involved in the scheme had substantial undistributed profits. If not distributed by year end, the companies would have been taxed on them (at 15 shillings in the pound). If those profits were distributed as dividends, the shareholders would have been taxed at the same rate. The purpose of the scheme was to permit the bulk of those funds to be retained by the companies pursuant to recapitalisations carried out in a way which attracted comparatively little tax. The Privy Council decision dismissed the applicable only to shams, no fiscal effects and accrued liabilities only arguments.

Lord Denning explained the operation of s 260 in this way:¹⁶

In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares cum dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to

¹² See s 5 of the *Interpretation Act 1999* (NZ).

¹³ Section 5(1).

¹⁴ *Newton*, above n 4.

¹⁵ *Income Tax and Social Services Contribution Assessment Act 1936–1950* (Cth).

¹⁶ At 8.

avoid [the relevant] tax: see *W. P. Keighery Pty. Ltd. v Commissioner of Taxation*

...

Lord Denning seems to have approached s 260 on the basis that, with the exclusion in relation to ordinary business and family dealings, there was no unacceptable tension with the rest of the Act and, in particular, that s 260, once engaged, would prevail over whatever other tax provisions the taxpayer might rely on. If this is so, his reference to, and approval of, *WP Keighery Pty Ltd v Federal Commissioner of Taxation*¹⁷ introduced a distinctly discordant element. His brief description of the arrangement in *Keighery* ('a private company [being] turned into a non-private company') did not do justice to the detail of an arrangement which was plainly predicated substantially, and perhaps solely, on the avoidance of tax. *Keighery* stands for the choice principle much relied on by taxpayers¹⁸ and the Privy Council's apparent endorsement of *Keighery* in *Newton* created problems not resolved in New Zealand until *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* and *Penny and Hooper v Commissioner of Inland Revenue*.¹⁹

IV *ELMIGER v COMMISSIONER OF INLAND REVENUE*

When s 108 was first relied on by the Commissioner, a narrow approach was favoured.²⁰ In 1966 there was, however, a distinct change in course with the judgment of Woodhouse J at first instance in *Elmiger v Commissioner of Inland Revenue*.²¹

Elmiger concerned the tax affairs of a partnership involved in earthmoving. The partners transferred earth moving machinery to a trust which they controlled but which, while it operated, was for the benefit of their wives and children. The trust was to terminate after some five and a half years and its assets were to revert to the partners unless they otherwise directed. As first struck, the trust gobbled up entirely what would otherwise have been the annual profit of the partnership. This resulted in the partners in their dual capacity as partners and trustees reducing the rent; but, even so, it still represented approximately half of what would otherwise have been the profit of the partnership. For practical purposes the money generated by the business activities of the partnership was subject to the control of the partners and dealt with as they wished.

Woodhouse J made short work of the argument that the differences between s 260 of the Australian Act and s 108 of the 1954 Act were material.²² So he concluded that *Newton* was controlling. He rejected the argument that s 108 was applicable to shams only, no fiscal effect and accrued liabilities only arguments.²³ He also concluded that s 108 could be invoked so as to disallow a deduction which, but for s 108, would have been allowed under s 111, the general

¹⁷ *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66.

¹⁸ In *Keighery* Dixon CJ, Kitto and Taylor JJ observed at 92: 'Whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them.'

¹⁹ *Ben Nevis*, above n 10; and *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433. See Part IX below.

²⁰ *Lewis v Commissioner of Inland Revenue* [1965] NZLR 634 (SC).

²¹ *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683 (SC) [*Elmiger* (SC)].

²² At 689.

²³ At 689-92.

deductibility provision, of the 1954 Act.²⁴ In doing so, he was not moved by the indication given by Dixon CJ in *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*²⁵ that s 260 could not be relied on to disallow a deduction otherwise permitted. As to this he noted:²⁶

In any event it is my opinion that s. 108 is part of the law to be applied and must be given its appropriate place in the statute ... I can see no reason why s. 111 should act in such a way as to override the effect of s. 108, and with all respect, I think this last section will operate to exclude a deduction if this arises as the result of an arrangement of the type struck at by s. 108.

More generally he observed:

The section is not designed to prevent ordinary commercial, or family, or charitable dispositions. Nevertheless this is a general provision aimed at otherwise legal methods of tax avoidance. It is designed, as I stated earlier, to forestall the use by individual taxpayers of ordinary legal processes for the deliberate purpose of obtaining a relief from the natural burden of taxation denied generally to the same class of taxpayer. Accordingly it is my opinion that family or business dealings will be caught by s. 108 despite their characterisation as such, if there is associated with them the additional purpose or effect of tax relief (in the sense contemplated by the section) pursued as a goal in itself and not arising as a natural incident of some other purpose.

This judgment was upheld by the Court of Appeal.²⁷ For the purposes of this paper it is sufficient to say that in dismissing the appeal the Court of Appeal largely adopted the approach taken by Woodhouse J.

The *Elmiger* approach gave practical effect to s 108. However, it did so primarily on the basis of *Newton*, effectively along the lines that providing a sensible and practical approach was taken to what amounted to tax avoidance – that is, what was truly within the scope of s 108 – any priority issue as between s 108 and other provisions resolved itself (in favour of s 108). Woodhouse J's explanation as to why s 108 prevailed over s 111 is limited and, as expressed, rather conclusory, albeit that it was based on Australian authorities to which he had earlier referred.

In the years that followed *Elmiger*, s 108 was often in issue in the courts. Taxpayers on occasion succeeded because of the absence of a power of reconstruction but in most cases the courts struck down the challenged transactions.²⁸ Save in cases which turned on the absence of a reconstruction power, application of the *Elmiger* approach was largely unproblematic (albeit that there was, on occasion, a diversity of judicial opinion as to outcome). For the purposes of my paper, these cases are of limited significance and the next important decision is that of the Privy Council in *Mangin v Commissioner of Inland Revenue*,²⁹ to which I now turn.

²⁴ At 692–3.

²⁵ *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 at 438.

²⁶ *Elmiger* (SC), above n 21, at 693.

²⁷ *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA).

²⁸ The cases are reviewed in detail in the judgment of Richardson J in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) [*Challenge* (CA)] at 546–7.

²⁹ *Mangin*, above n 1.

V MANGIN V COMMISSIONER OF INLAND REVENUE

Mangin involved a 'paddock trust', an income-splitting device reasonably similar to that adopted in *Elmiger*. Once again the 'no fiscal effect' and 'accrued liabilities only' arguments were rejected,³⁰ as was the taxpayer's appeal. The case, however, was far from an unqualified victory for the Commissioner as is apparent from the following passage from the judgment of the majority:³¹

In their Lordships' view [Lord Denning's discussion of predication in *Newton*], properly interpreted, does not mean that every transaction having as one of its ingredients some tax saving feature thereby becomes caught by a section such as s 108. If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think s 108 can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen. Indeed, in the case of a company, it may be the duty of the directors vis-à-vis their shareholders so to act. ... The clue to Lord Denning's meaning lies in the words 'without necessarily being labelled as a means to avoid tax' ... Their Lordships think that what this phrase refers to is, to adopt the language of *Turner J* in the present case 'a scheme... devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived.'

This suggests that a taxpayer may elect the most tax-effective way of implementing a bona fide transaction, with the GAAR inapplicable unless the sole or principal purpose was tax avoidance (in which case, it would presumably not be a bona fide transaction). This was a substantially watered down version of the predication test from that adopted in *Elmiger* (which applied if there was an 'additional purpose' of tax avoidance 'pursued as a goal in itself')³² and thus left considerable scope for the operation of the choice principle.

Also significant for the purposes of my paper is the dissenting judgment of Lord Wilberforce. He identified four unsatisfactory features of s 108:³³

(a) It fails to define the nature of the liability to tax, avoidance of which is attacked. Is this an accrued liability, a future but probable liability, or a future hypothetical liability? Is it one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if 'might', probably might or ordinarily might or conceivably might?

(b) It fails to specify any circumstances in which arrangements etc which in fact have fiscal consequence may be outside the section, and, if such exist, to specify on whom the onus lies, and to the satisfaction of whom, to establish the existence of such circumstances. The taxpayer is left to work his way through a jungle of words, 'purpose', 'or', 'effect', 'purported purpose', 'purported effect' which existing decisions have glossed but only dimly illuminated.

(c) It fails to specify the relation between the section and other provisions in the Income Tax legislation under which tax reliefs, or exemptions, may be

³⁰ At 594–6.

³¹ At 598.

³² See Woodhouse J's more general observations in Part IV above, in quotation immediately before footnote 28.

³³ *Mangin*, above n 1, at 602.

obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between 'proper' tax avoidance and 'improper' tax avoidance? By what sense is this distinction to be perceived?

(d) It gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement

He then went on:³⁴

In Australia and New Zealand the Courts have endeavoured to remedy some of the statutory deficiencies. In *Newton v Commissioner of Taxation* ..., this Board gave some fresh life to the Australian section by instancing transactions 'capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax', a suggestion profitably generalised by Kitto J in the words 'capable of explanation by reference to ordinary dealing such as business or family dealing ...' (*Hancock v Commissioner of Taxation* (1961) 108 CLR 258, 283) but it could hardly be claimed that these are indications of precision. They have in turn been 'interpreted' in the majority decision in this case. But one difficulty leads to another, and the Courts are now having to decide how 'ordinary' a transaction must be to escape. In the present case, the Judges have, not surprisingly, reached differing conclusions: Wilson J thought the transactions were ordinary: the Court of Appeal found that they were extraordinary.

...

It is because I believe that the limits of judicial interpretation, however liberal or common sense the process may be claimed to be, are passed when one comes to attempt to apply the New Zealand section to this present case that I cannot agree with the Board's decision. I think that we have here a rusty instrument which breaks in our hands and is no longer capable of repair.

I have set out in full the problems identified by Lord Wilberforce even though his (a) was addressed in part to the accrued liabilities only argument and his (d) to the absence of a reconstructive power argument. These problems were addressed (although as to (a) perhaps only in part) by the 1974 amendments to s 108 and thus in s 99 of the 1976 Act, to which I am about to turn. Points (b) and (c) were not, however addressed by the legislature in 1974 and remain unaddressed to this day.

VI THE LEGISLATURE RESPONDS

Section 108 had been amended in 1968 so as to make it clear that the section had fiscal effect.³⁵ As I have noted, s 108 was amended in 1974³⁶ and the amended provision was

³⁴ At 602.

³⁵ By inserting after the words 'absolutely void', the words 'as against the Commissioner for income tax purposes': see s 16(1) of the Land and Income Tax Amendment Act (No 2) 1968. In *Mangin*, above n 1, the majority concluded at 595 that this merely confirmed the existing law.

³⁶ By s 9 of the Land and Income Tax Amendment Act (No 2) 1974. The immediate trigger for the amendment appears to have been *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279 (CA) where the Commissioner's case had failed for want of a power of reconstruction.

carried through into the 1976 Act as s 99. The revised section conferred on the Commissioner a power of reconstruction.³⁷ It also made it clear that it was applicable in respect of arrangements affecting 'potential or prospective liability in respect of future income'.³⁸ And finally, there was a response to the majority's judgment in *Mangin*, in that the amended section declared that it applied to an arrangement if:³⁹

(a) *Its purpose or effect is tax avoidance; or*

(b) *Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings ...*

It is sometimes said that this represented an abrogation of the predication test.⁴⁰ I have distinct reservations whether this is so. In *Newton*, Lord Denning acknowledged that the avoidance of tax was not the sole purpose of the arrangements in the cases at hand. But he then went on to say:⁴¹

But nevertheless the section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says 'so far as it has' the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose.

This is consistent with the approach adopted in *Elmiger* but not with the sole or principal purpose view advanced in *Mangin*. I therefore prefer to see this amendment as a repudiation of this aspect of the *Mangin* judgment.

Although the 1974 amendment and thus s 99 of the 1976 Act did not address points (b) and (c) as identified by Lord Wilberforce, they made it clear that the legislature expected the GAAR to be an effective part of the tax system.

VII *EUROPA OIL (NZ) LTD v COMMISSIONER OF INLAND REVENUE*

The argument that s 108 could not prevail against s 111 (the general deductibility provision) was adopted by the Privy Council in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue*.⁴² In issue was the deductibility of the full cost to the taxpayer of acquiring its stock-in-trade. The payments for which deductibility was sought enabled the taxpayer to derive not just the stock but also benefits of a non-taxable nature which mitigated the economic burden of the cost of the stock purchases. The taxpayer was successful in the Privy Council for reasons which included priority being accorded to s 111 over s 108:⁴³

Their Lordships' finding that the monies paid by the taxpayer company ... is deductible under s 111 as being the actual price paid by the taxpayer company for its stock-in-trade under contracts for the sale of goods entered into with Europa

³⁷ Section 9(2).

³⁸ Section 99(1), definition of 'liability'.

³⁹ Section 99(2).

⁴⁰ See for instance *Ben Nevis*, above n 10, at [81] per Tipping, McGrath and Gault JJ.

⁴¹ *Newton*, above n 4, at 10 (emphasis original).

⁴² *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC).

⁴³ At 556 per Lord Diplock for the majority.

Refining ... is incompatible with those contracts being liable to avoidance under s 108. In respect of these contracts the case is on all fours with *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 in which it was said by the High Court of Australia 'it is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income' (ibid p 434).

This limited view of the GAAR was inconsistent with that adopted in *Elmiger* albeit that this was not adverted to in the judgment. This surprisingly casual approach to over-ruling earlier authority was soon to be repeated, only this time in relation to this passage in *Europa*; this occurring in the next case I wish to discuss, *Challenge Corporation Ltd v Commissioner of Inland Revenue*.⁴⁴

VIII CHALLENGE CORPORATION LTD V COMMISSIONER OF INLAND REVENUE

This involved a scheme under which the taxpayer acquired from Merbank (a failed financier) a company (Perth) with tax losses and claimed under s 191 of the 1976 Act to offset those losses against the income of profitable subsidiaries. That section contained a specific but limited anti-avoidance subsection (s 191(1)(c)(i)) in relation to arrangements of a temporary nature. This subsection was not engaged and the conditions for grouping specified in s 191 (which were required to be satisfied on the last day of the income year) were all satisfied. The effect of the arrangement, entered into near the end of the income year, was to allow Challenge to take advantage of tax losses previously incurred by Perth, that is, at a time when it had no association with Challenge. Section 191 did not make earlier association a pre-condition to grouping.

It was clear that the whole purpose of the transaction was to obtain a tax advantage. The same, however, was true of any arrangement involving the grouping of tax losses, including those well within the spirit, as well as the letter, of s 191. The predication approach thus did not provide a mechanism for distinguishing between objectionable and unobjectionable grouping arrangements.

The Commissioner was unsuccessful at first instance⁴⁵ and in the Court of Appeal.⁴⁶ That Court comprised Woodhouse P, and Cooke and Richardson JJ. For the purposes of this paper, I propose to focus on the approaches adopted by Woodhouse P and Richardson J. Cooke J agreed in the result and largely with the reasons of Richardson J.

Woodhouse P noted the criticisms of s 108 advanced by Lord Wilberforce in *Mangin* and then went on:⁴⁷

But the *Mangin* case was heard and disposed of by the Board in 1970, about four years before Parliament took legislative steps to meet at least some of the judicial criticisms of s 108. And I think there can be no doubt that when the provision was amplified and given its present statutory form by Parliament in 1974 the deliberate decision was then taken that, because the problem of definition in this elusive field could not be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the

⁴⁴ *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC) [*Challenge* (PC)].

⁴⁵ *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (HC).

⁴⁶ *Challenge* (CA), above n 28.

⁴⁷ At 534.

Judges. ... It can be said, I think, ... that inherent in the approach taken by Parliament is an assurance that some expressed judicial misgivings as to the proper role of the Court concerning the earlier legislation have been misplaced. Most certainly it was open to Parliament to take this approach and I do not accept the view that any of the supposed problems of construing s 99 should persuade the Courts that they cannot be resolved by judicial interpretation and so must be left for yet further legislative attention.

He roundly rejected the choice principle⁴⁸ and then went on to consider whether s 191 should prevail over s 99:⁴⁹

For a number of reasons I am unable to accept these arguments. First, it would be quite extraordinary, ... for the draftsman to carefully prevent a tax advantage because the shareholding was 'of a temporary nature' and yet consciously decide that Parliament would wish to give its blessing (and then only by implication) to a manufactured and barely tangible association of the kind under review. ... I think it far more likely that after drawing express attention to the obvious tax avoidance implications that could arise from shareholdings 'of a temporary nature' he decided that all other tax avoidance situations should properly be left for attention by s 99. It may even be that these other matters were not in mind or the subject of any deliberate decision ...

This leads to the second point. Paragraph (c)(i) could be construed as filling the avoidance field in so far as s 191 is concerned only on the basis that the much wider provisions of s 99 were excluded by an implication. I do not think such an important gloss can be read into the paragraph and against the plain language of s 99 recognised by counsel ... as 'a central pillar of the income tax legislation'.

Finally it needs to be remembered when construing s 99 beside s 191 that s 191 does not open with such words as 'Notwithstanding the provisions of s 99 ...'. If Parliament had intended that s 191 should stand quite independently of and unaffected by the earlier section it would have been a simple matter to say so in express terms.

...

For the foregoing reasons I think that s 99 is of general application, that s 191 is subordinate to it, and that it is intended to operate as a kind of proviso to other provisions of the Act wherever the issue of tax avoidance may seem to have relevance. Accordingly I am of the opinion that the appeal should be allowed and the assessment of the Commissioner reinstated.

In part, Woodhouse P was applying the *generalia specialibus* maxim in favour of s 99. What he did not spell out, however, is why, if s 99 was 'a kind of proviso' to s 191, it would not invalidate every grouping arrangement, including those within the spirit of s 191. With what is no doubt the benefit of hindsight, I am inclined to see in the italicised passages a possible explanation in terms of what are at least hints of an embryonic parliamentary contemplation test.

⁴⁸ At 538–539.

⁴⁹ At 539 (emphasis added).

Richardson J was distinctly more sympathetic to the choice principle than Woodhouse P. He expressed his general interpretative approach in this way:⁵⁰

Section 99 ... lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. ...

Certainly the scheme and purpose approach to statutory analysis will not furnish an automatic easy answer to these interpretation problems. Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. There is force in the thesis that in many respects the tax base is so inconsistent and contains so many structural inequities that a single general anti-avoidance provision such as s 99 cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences.... Nevertheless, that emphasis on trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between s 99 and other provisions of the Act that best reflects the intention of Parliament as expressed in the statute.

He applied this approach in this way:⁵¹

Section 191 is a complex provision which has been changed, developed and refined by legislative amendment over a number of years. Basic to its operation is the establishment of common shareholdings, voting power or entitlement to profits (and, in the course of full grouping, of an identical pattern of shareholding) at particular times. The only requirement in that regard applying ... [at] the material time was that the test be satisfied on a particular day — at the end of the income year. ... A specific anti-avoidance provision, obviously drafted with the language of the old s 108 in mind, was directed and confined to temporary changes of shareholding for the purpose or effect of altering the incidence of income tax or relieving any company from its liability to pay income tax by excluding any company from or including it in any group of companies in relation to that income year.

The nature of s 191 and these features of the scheme of the section at the material time do not ... leave any room for the application of s 99 to these straightforward arrangements which did no more than bring the loss companies within a new group so as to satisfy all the requirements of s 191. It is no answer to say that the purpose of the arrangement was to save tax for that is the purpose of every offset of a loss in one company against a profit in another, which is the only reason for the presence of s 191 in the statute ...

On this analysis of the role of s 191 in the statutory scheme and of the terms of the provision itself I am satisfied that to treat the arrangements carried through in this

⁵⁰ At 549. The 1924 Act referred to in this passage preceded, and was repealed by, the *Interpretation Act 1999*, referred to in Part II above, text near footnotes 13 and 14.

⁵¹ At 555 (emphasis added).

case as tax avoidance within s 99(1) would defeat, not promote the legislative purposes involved. The tax changes achieved in the transactions did not alter the incidence of income tax which the Act itself contemplated or affect Challenge's liability for income tax in the sense indicated by the statute.

Richardson J addressed priority as between ss 99 and 191 in general terms – that is in terms of whether s 99 or s 191 should prevail where the predication test is satisfied. Since (a) the predication test is always satisfied where tax losses are grouped and (b) the legislature nonetheless intended that tax losses could be grouped, the predication test was not, in itself, an answer to the taxpayer's argument. So I agree with Richardson J that the case was not susceptible to resolution on the basis that s 99 always trumped s 191. Where I differ from him – and again with the benefit of hindsight – is that I do not regard the case as turning on a general issue priority (or subordination) as between ss 99 and 191. Instead I see it as turning on whether, *on the facts of the case at hand*, s 99 or s 191 prevailed – a sui generis issue of both interpretation and application and not susceptible to sensible resolution simply on the basis of a straight-forward 'scheme and purpose' legislative analysis as to general priority between the two sections.

The Privy Council allowed the Commissioner's appeal in a majority judgment delivered by Lord Templeman.⁵² This was expressed in terms distinctly unsympathetic to taxpayers. Lord Templeman summarily rejected the contention that s 99 could not apply if s 191 was satisfied.⁵³

Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. Section 99 would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust s 99.

The position advanced in *Cecil Bros* and adopted by the Privy Council in *Europa* was thus rejected; albeit with an absence of reference to the conflicting authorities corresponding to the failure of the Privy Council in *Europa* to refer to *Elmiger*.

Lord Templeman likewise rejected the contention that s 191(1)(c)(i) excluded the operation of s 99. He paraphrased the argument advanced by the taxpayer in deliberately unpersuasive terms:⁵⁴

Parliament must have intended that any permanent form of tax avoidance or any other form of tax avoidance except the particular form prescribed by s 191(1)(c)(i) should be permitted to succeed.

He then, unsurprisingly, rejected the argument:⁵⁵

In the opinion of the Board this argument attributes to Parliament a benevolent attitude towards tax avoidance by companies which is unlikely and unnecessary.

A likely explanation is that Parliament was indifferent to or unmindful of any overlap between the general provisions of s 99 and the particular provisions of s 191(1)(c)(i) or that, in view of the well-known difficulties encountered in the formulation and enforcement of effective anti-tax avoidance provisions,

⁵² *Challenge* (PC), above n 44.

⁵³ At 559.

⁵⁴ At 559.

⁵⁵ At 559 (emphasis added).

Parliament thought that an overlap might be useful and could not be harmful. Parliament may have had in mind two different tax avoidance positions. There could be tax avoidance in the introduction into a group of companies of a company which had already made a loss; any tax advantage obtained as a result of that introduction would fall foul of s 99. There could also be tax avoidance in the manipulation of the shareholdings or constitution of a company in order to obtain temporary compliance with the conditions specified by s 191; that manipulation would fall foul of s 191(1)(c)(i). The possibility that such manipulation might also be frustrated by the operation of s 99 does not lead to the conclusion that Parliament must have intended to permit permanent tax avoidance schemes to exploit s 191. The provisions of s 99 are of general application and, in the absence of an express direction by Parliament excluding s 191 from the ambit of s 99, their Lordships consider that s 99 must be applied in the present circumstances.

Lord Templeman also gave some explanation as to why s 99 would not always trump s 191:⁵⁶

It was argued that if this appeal by the Commissioner succeeds a purchase of shares in a company which becomes part of a specified group will always be void under s 99. But a purchase of shares will only be void in so far as it leads to tax avoidance and not tax mitigation.

In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.

...

Most tax avoidance involves a pretence; see the analysis in *WT Ramsay Ltd v Inland Revenue Commissioners* [1979] 1 WLR 974, 975 (CA). In the present case Challenge and their taxpayer subsidiaries pretend that they suffered a loss when in truth the loss was sustained by Perth and suffered by Merbank.

The judgment is very much along the same lines as the current parliamentary contemplation test. Certain economic effects were seen by the legislature as warranting the benefit in question. If those economic effects had been suffered, s 191 would have prevailed. But Challenge had not suffered those economic effects. It was thus seeking to obtain a tax benefit in circumstances other than those intended by the legislature. Therefore s 99 prevailed, on the facts of the case, against s 191.

This does not look like orthodox scheme and purpose analysis in that it was not concerned with the meaning of s 191, which, in this respect, was plain enough. The premise of the case is that, absent the invocation of s 99, the scheme was effective and s 191 was complied with. The practical effect of the decision was that, with s 99 engaged, the entitlement to group losses was dependent upon the companies concerned having been associated at the time the losses were incurred; this despite such a condition not being specified in s 191.

⁵⁶ At 562 (emphasis added).

IX INCOHERENCE AND INDETERMINACY

In the aftermath of *Challenge*, the *Cecil Bros/Europa* view that the GAAR could not be invoked to disallow a tax consequence created by some other provision of the Act was never revived. But the view of Woodhouse P that the GAAR was a trumping provision was likewise not adopted. The choice principle was still in play but its scope was uncertain. The expression 'line drawing' came into vogue. More generally, the law was characterised by incoherence and indeterminacy.

The position was summarised by Richardson P (writing for himself, Keith and Tipping JJ) in this way in *Commissioner of Inland Revenue v BNZ Investments Ltd*:⁵⁷

[39] For the reasons discussed in the cases ... s 99 as the expanded successor of the old s 108 of the Land and Income Tax Act 1954 is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature through s 99 has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.

[40] Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice – as Lord Templeman put it ... most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values.

[41] The function of s 99 is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that s 99 should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all the specific provisions of the tax legislation. It, too, is specific in the sense of being specifically directed against tax avoidance; and it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation. The general anti-avoidance section thus represents an uneasy compromise in the income tax legislation.

[42] Line drawing represents the legislature's balancing of the relevant public interest considerations. ...

At times a conservative approach to the GAAR was proposed or applied. Thus in *Commissioner of Inland Revenue v Auckland Harbour Board*⁵⁸ Lord Hoffmann referred, in

⁵⁷ *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA).

⁵⁸ *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] UKPC 1, [2001] 3 NZLR 289.

passing, to s 99 as a 'long stop for The Revenue'.⁵⁹ And although the long-stop view was not expressly referred to in the later Privy Council decision, *Peterson v Commissioner of Inland Revenue*,⁶⁰ it might be thought to be consistent with the result. The case concerned non-recourse loan financing of film investments. The non-recourse loan was referred to in the judgment as '\$y' whereas as the money directly paid by the investors for production costs was referred to as '\$x'. Ostensibly each investor had paid a total of \$x+y for production costs.

There was, as one might expect, circularity in relation to the no-recourse loan which did not represent 'real' money.

In allowing an appeal by Peterson from a finding in favour of the Commissioner, the majority observed:

[44] The leverage obtained by use of a non-recourse loan meant that the investors did not sustain an economic loss after the tax deduction is taken into account. Their Lordships suspect that it is this feature of the scheme which has most exercised the Commissioner. But a moment's reflection shows that what Lord Templeman had in mind [in Challenge] was expenditure or loss before any tax advantage is taken into account. ... The fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of \$x+y. It was not and could not be suggested that either loan was on terms which meant that it was unlikely ever to be repaid. The investors have repaid one of the loans in whole or in part, albeit out of the film receipts; and they incurred a liability to repay the other if the film generated sufficient receipts, as it was hoped it would.

[45] The circular movement of money sometimes conceals the fact there is no underlying activity at all. But each of the payments in the circle must be examined in turn to see whether it discharged a genuine liability of the party making the payment. It does not matter whether external funds were introduced into the circle or whether cheques were handed over and duly honoured. If the money movements did not discharge a genuine liability the introduction of external funds will not save it; if they did, their absence will not affect it. ... On the way in which the Commissioner put his case the relevant payments were those by which the investors received the non-recourse loan and paid it out to the production company. Subsequent payments through the circle of which the investors were unaware and which they could not control or prevent did not alter the fact that they had borrowed \$y and used it towards the discharge of their liability to pay \$x+y to the production company, thereby suffering the loss or incurring the relevant expenditure for which the depreciation allowance is granted.

[46] The \$x+y was ostensibly paid as consideration for the acquisition of the film, and while the Commissioner was at pains to argue that it was never 'truly' paid, it was no part of his case at any stage that it was paid for any other purpose. Before the Board he conceded that it was paid as consideration for the making of the film. Their Lordships consider that this concession, which was inevitable from the way in which the Commissioner has conducted the case throughout, is fatal to his case.

All in all *Peterson* represented a very tolerant approach to tax avoidance. But in the meantime, back in New Zealand, a rather different approach was beginning to develop.

⁵⁹ At [11].

⁶⁰ *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5, [2006] 3 NZLR 433.

X BEN NEVIS FORESTRY VENTURE LTD V COMMISSIONER OF INLAND REVENUE

*Ben Nevis Forestry Venture Ltd v Commissioner of Inland Revenue*⁶¹ concerned the Trinity scheme. This involved a series of related forestry investments associated with a substantial Douglas fir forest which had been planted and was growing in Southland. The taxpayers were members of syndicate which took a licence from a Trinity company over the land in issue and were required to make payments as follows:

- (a) On 21 March 1997, \$1,350 per plantable hectare to establish the forest.
- (b) Also on 21 March 1997, \$1,946 per plantable hectare. The primary purpose of this payment was to acquire the land in 2048 for 50 per cent of its then value.
- (c) Also on 21 March 1997, \$1,000 each, in relation to a lease option.
- (d) \$50 per annum per plantable hectare by way of licence fee.
- (e) On 31 December 2048, \$2,050,518 per plantable hectare as a licence premium.

In return for this, the taxpayers were to receive the net stumpage derived from the sale of the forest and an option to acquire the land for 50 per cent of its then value.

The profitability of the venture depended on whether the net stumpage which the taxpayers should receive on the sale of the forest would cover the costs (including the time value of money) of their investment. In relation to the requirement to pay the licence premium of \$2,050,518 in 2048, the risk of insufficient stumpage was addressed by an associated insurance arrangement under which the taxpayers paid or agreed to pay to an insurer, CSI, per plantable hectare:

- (a) in 1997, \$1,307; and
- (b) by 31 December 2047, \$32,791.

CSI was established in the British Virgin Islands on the instructions of the scheme architects. A draft business plan for CSI noted:

The real benefits of the deal are tax concessions that can be obtained now by the investors and the foundation. One of the conditions required to gain the tax relief is that the insurance must be in place. The actual outcome of the deal in 50 years time is not considered material.

The tax benefits sought by the taxpayers were substantial. For the 1997 year, for each plantable hectare, the taxpayers expended a little under \$5,000 and ostensibly achieved a deduction in excess of \$37,000. For the 1998 income year – and leaving aside silviculture costs – the corresponding figures were \$50 (expenditure) and \$41,000 (deduction).

The case might be thought to have involved accrual issues, albeit that these were not fully ventilated in the main tax litigation, a point which itself has been subject to much later litigation.⁶² The case was thus argued as to black letter compliance with the provisions relied on by the taxpayers and the impact of s BG 1. The taxpayers were generally successful on the technical compliance issues and the case was determined under s BG 1.

⁶¹ *Ben Nevis*, above n 10.

⁶² *Commissioner of Inland Revenue v Redcliffe Forestry Venture Ltd* [2012] NZSC 94, [2013] 1 NZLR 804.

The taxpayers were unsuccessful at first instance⁶³ and appealed to the Court of Appeal.⁶⁴ In the course of delivering the judgment of that Court dismissing the appeal, I expressed an approach which I thought to be then available on the authorities as to inconsistency between the GAAR and the specific provisions relied on by the taxpayers:⁶⁵

[125] Obviously, there is a need to recognise that in some instances the legislature must have intended to encourage particular types of behaviour. Behaviour of that type (being the sort of behaviour which was within the contemplation of the legislature) cannot be within the general avoidance provisions because the overall legislative purpose is that such behaviour should attract the tax consequences provided for by Parliament. Likewise, it may sometimes be obvious that the specific tax rules relied on were not intended to confer the tax benefit in issue. Such a case, however, is likely to be decided simply by construing the relevant specific tax rules so as to accord with the legislative intent and without any need to resort to the general anti-avoidance provisions.

[126] Cases which lie in between the two extremes just identified still raise a question of statutory interpretation but one which, in our view, cannot be addressed solely by reference to the specific tax rules relied on by the taxpayer. The relevant general anti-avoidance provisions are also relevant. ... When construing such specific rules and looking for their scheme and purpose, it is necessary to keep general anti-avoidance provisions steadily in mind. On this basis, it will usually be safe to infer that specific tax rules as to deductibility are premised on the assumption that they should only be invoked in relation to the incurring of real economic consequences of the type contemplated by the legislature when the rules were enacted. Further, it also seems reasonable to assume that deductibility rules are premised on a legislative assumption that they will only be invoked by those who engage in business activities for the purpose of making a profit. Further, schemes which come within the letter of specific tax deductibility rules by means of contrivance or pretence are candidates for avoidance...

As will be apparent, this is very largely founded on Lord Templeman's judgment in *Challenge*, albeit expressed in terms which are reasonably consistent with orthodox interpretation principles. I also expressed a tentative preference for the more direct and simple approach of according the GAAR a primacy over other tax provisions to be 'displaced only when there is a discernible legislative intention that a particular type of transaction' should not be subject to the GAAR.⁶⁶ I considered, however that adoption of that approach was beyond the role of the Court of Appeal, given recent authority, and in particular *Peterson*.⁶⁷

The case went on appeal to the Supreme Court and the appeals were dismissed. The essence of the approach is captured in the following passage from the judgment of Tipping, McGrath and Gault JJ:⁶⁸

[107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The

⁶³ *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC).

⁶⁴ *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230 (2007) 23 NZTC 21,323.

⁶⁵ Emphasis in original.

⁶⁶ At [114].

⁶⁷ At [115].

⁶⁸ *Ben Nevis*, above n 10.

taxpayer must satisfy the court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement. ...

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

[109] ... The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

XI *PENNY AND HOOPER V COMMISSIONER OF INLAND REVENUE*

In *Penny and Hooper v Commissioner of Inland Revenue*⁶⁹ the taxpayers were orthopaedic surgeons who practised through companies. In each case, the company was owned by a family trust or trusts and the taxpayer was the sole director. After the top personal rate of income tax was increased from 33 to 39 per cent in 2000, the companies paid (a) salaries to the taxpayers materially lower than had previously been fixed; and (b) dividends (taxed at 33 per cent or less) to the family trusts which were correspondingly higher.

Being of the view that these arrangements constituted tax avoidance, the Commissioner recalculated the surgeons' incomes by attributing to each what he considered to be a 'commercially realistic salary'. The facts of the case were remarkably similar to those in *Peate v Federal Commissioner of Taxation*,⁷⁰ albeit that, and oddly, the judgment of the High Court of Australia was not referred to until the hearing before the Supreme Court.⁷¹

The taxpayers were unsuccessful in the Supreme Court for the reasons explained by Blanchard J. He set the scene in this way:⁷²

[33] ... The structure both taxpayers adopted when they transferred their businesses (orthopaedic practices) to companies owned by their family trusts was, as a structure, entirely lawful and unremarkable. The adoption of such a familiar trading structure cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make. Nor is there anything unusual or artificial in a taxpayer then causing the company under his control to employ him on a salaried basis. What is said by the Commissioner to constitute tax avoidance

⁶⁹ *Penny and Hooper*, above n 19.

⁷⁰ *Peate v The Commissioner of Taxation of the Commonwealth of Australia* (1962) 111 CLR 443.

⁷¹ As noted by Blanchard J at [38], the subsequent Privy Council decision (*Peate v Commissioner of Taxation of Commonwealth of Australia* [1967] 1 AC 308 (PC)) was referred to in passing in written submissions.

⁷² References omitted.

is the fixing of the salaries at artificially low levels whereby the incidence of tax at the highest personal rate was avoided. It can hardly be a coincidence that this was done as soon as that personal tax rate was increased to 39 cents in the dollar, and not before that change was made by Parliament. But, again, there was no failure to comply with any express requirement of the Act in the setting of the salaries, since there is none. This is therefore a case in which, compliance in other respects being accepted, it is possible to move straight to s BG 1 and to ask whether the use of the structure which was adopted when the salaries were fixed was beyond parliamentary contemplation and resulted in a tax avoidance arrangement. ...

After referring to and discussing *Peate*, Blanchard J went on:⁷³

[47] Although the New Zealand tax statute and some business practices have changed considerably in the intervening period [since the 1960s], Parliament has deliberately preserved, and in fact enlarged, the New Zealand general anti-avoidance provision which corresponded to s 260 in *Peate*. It continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of 'ordinary business or family dealings' unless any tax advantage is just an incidental feature. ... Woodhouse P said in *Challenge Corporation Ltd v Commissioner of Inland Revenue* that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages. That is what the artificially low salary settings did in this case. They reduced each taxpayer's earnings but at the same time enabled the company's earnings (derived only because of the setting of the salary levels) to be made available to him through the family trusts. In reality, the taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had, to adapt Lord Templeman's dictum in *Challenge*.

XII SUBSEQUENT LITIGATION

More recent major tax avoidance cases which did not reach the Supreme Court provide examples of the application of the parliamentary contemplation test.

Two of the cases involved repo deals entered into by BNZ and Westpac. At a preliminary stage of one of the cases, I explained the transactions in issue in this way:⁷⁴

(a) A subsidiary of the BNZ (the BNZ subsidiary) would acquire from a counter-party an equity or trust interest in an overseas entity (the issuer) on the basis that the counter-party would repurchase that interest (at the same price, subject to adjustments) at a specified time (usually five years) with the counter-party's parent company guaranteeing performance. In economic substance, the BNZ subsidiary was thus providing funding to the counter-party. The BNZ subsidiary's initial return was in the form of distributions from the issuer.

(b) The return to the BNZ group and the overall balance of advantage between the bank and the counter-party is a function of the agreed distribution to be made by the issuer to the BNZ subsidiary, the interest rate swap arrangement, the

⁷³ References omitted.

⁷⁴ *BNZ Investments Ltd v Commissioner of Inland Revenue* [2007] NZCA 356, [2008] 1 NZLR 598 at [7].

guarantee procurement fee (the GPF) (at 2.95 per cent of the purchase price) paid by the BNZ subsidiary for procuring the performance guarantee from the parent company of the counter-party, and the bank's borrowing costs.

(c) The BNZ group would deduct its cost of borrowing, the GPF and the net cost of the interest rate swap and treat distributions from the issuer as either: (i) exempt from tax on the basis that the distributions were received by an overseas owned company (as the BNZ subsidiary) from an overseas company (as the issuer would be) under the 'conduit' tax relief rules; or (ii) relieved from tax under the foreign tax credit rules on the basis a foreign tax credit was available for foreign tax paid by an overseas company (being the issuer) resulting in a full credit claimed under the foreign tax credit provisions.

In both cases, the Commissioner successfully contended in the High Court that that the transactions were devoid of commercial purpose other than the exploitation of a tax asymmetry, provided a mechanism by which the economic benefits of that exploitation could be divided up between the bank and counter-parties and should be avoided under s BG 1.⁷⁵ Appeals against the High Court judgments were later compromised. The cases are too complex for me, in this paper, to do justice to the reasoning. There is, however, one aspect of them which I should mention.

In the *BNZ* case, Wild J analysed carefully the conduit regime, including the pre-existing controlled foreign company (CFC) and dividend withholding payment (DWP) rules.⁷⁶ Income within the CFC rules attributed to New Zealand residents was taxed as it was earned. In cases where the New Zealand resident was owned by a non-resident, the effect was to tax the non-residents on foreign-sourced income. The conduit regime was intended to mitigate this consequence. If the New Zealand resident passed on the income to its non-resident owner, this would attract non-resident withholding tax. It is reasonably clear that those who promoted the conduit regime assumed that this would happen and such assumption is, at least to some extent, reflected in the legislative requirements as to the 'conduit tax relief accounts' which taxpayers must establish. (It is also implicit in the word 'conduit', at least if it is taken to refer to the income rather than capital flows.) What is significant for present purposes is that because the repo deals were all loss-incurring on a pre-tax basis, they never generated a profit which could be passed back to the non-resident owner of the BNZ. So no non-resident withholding tax was ever paid.

Entitlement to conduit tax relief was not conditional upon income being passed on to non-resident owners. As well, even when such income is passed on there will necessarily sometimes be mismatches in time and amount between the non-resident withholding tax which is paid and the relief obtained under the conduit regime. Wild J nonetheless felt able to conclude that:⁷⁷

The requirements [of the regime] are consistent only with Parliament contemplating that some of the conduit relieved income would in due course be passed on the foreign owner. Otherwise those requirements are pointless. It is also

⁷⁵ *BNZ Investments Ltd v The Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) [*BNZ Investments* (HC)]; and *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC).

⁷⁶ *BNZ Investments* (HC), above n 75, at [206]–[243].

⁷⁷ At [235].

difficult to conceive of a foreign owner not requiring some return on the foreign investment it made through its New Zealand subsidiary.

In this respect the judgment is similar to *Challenge* in that its effect was to make entitlement to a tax benefit subject to a condition (in this case, the eventual passing on to the foreign owner of all or some of the relieved income) additional to the conditions stipulated by Parliament.

The other case is *Alesco New Zealand Ltd v Commissioner of Inland Revenue*.⁷⁸ Alesco NZ acquired two other New Zealand companies. Those acquisitions were funded by Alesco NZ issuing a series of optional convertible notes (OCNs) to its Australian parent (Alesco Corp) for which it received \$78 million. In substance this was an interest free loan of \$78 million which was to be repaid at the expiry of 10 years. But on maturity Alesco Corp also had the option of converting the notes into shares. This option was of no practical utility as Alesco Corp already had 100 per cent ownership of Alesco NZ and it was therefore a distinctly artificial feature of the scheme.

Under the financial arrangement rules and the Commissioner's Determination G22,⁷⁹ the OCNs were split into debt and equity components with \$40 million of the \$78 million attributed to the option and \$38 million to the debt component. The debt component was treated as a bond issued for \$38 million with a redemption value of \$78 million. Leaving aside the effect of s BG 1, Alesco NZ was entitled to deduct the difference (\$40m) over the life of the OCNs. The redemption of the advance would not involve any Australian tax liability for Alesco Corp which was nonetheless entitled to full deductibility in respect of the debt taken on to fund the payments to Alesco NZ. There was thus a tax asymmetry which the scheme exploited.

A vanilla version of the funding arrangement in the form of an interest bearing advance from Alesco Corp to Alesco NZ would have resulted in tax deductions for Alesco NZ which would not have been less, and may well have been more, than those claimed. For this reason and given the tax advantages derived by Alesco Corp in Australia, it was argued that the Australian tax system was the primary target of the scheme. Arguments around these issues were addressed and rejected by the Court of Appeal. These arguments and the reasons the Court of Appeal gave for rejecting them are interesting but not material to the theme of this paper and I therefore leave them to one side.

Although referable to the need to fund business acquisitions and in that sense, in terms of purpose, bona fide or genuine, the transactions were contrived as to structure. Alesco NZ suffered no economic loss corresponding to the tax deduction claimed and the OCN documentation was itself artificial in relation to the optional conversion of the notes.

The Court of Appeal posed for itself the following questions:⁸⁰

[W]e are able to narrow the scope of debate at this stage of the inquiry to what appears to be the one decisive question: that is, if it is established that Alesco NZ did not incur either a legal liability to pay interest or any economic cost on the loan, did its use of the financial arrangements rules and G22 to claim income tax deductions for expenditure incurred fall outside Parliament's contemplation when

⁷⁸ *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

⁷⁹ An instrument issued by the Commissioner to provide a method for assessing income and costs on debt instruments.

⁸⁰ At [56] (references omitted).

enacting the rules? Or, expressed slightly differently, did Alesco NZ obtain a tax advantage without bearing the interest expense which Parliament intended to be suffered in order to fall within the deductibility provisions? Or, expressed differently again, should the anti-avoidance provisions be applied in a way which ignores the economic reality of the OCNs as contemplated by the deductibility provisions and G22?

In applying the parliamentary contemplation test, the Court commented:⁸¹

[71] In our judgment, the financial arrangements rules were intended to give effect to the reality of income and expenditure – that is, real economic benefits and costs. They were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment. The question is whether the taxpayer has ‘truly incurred the cost as intended by Parliament’. This construction is reinforced by the relevant addition, in three critical provisions, of the word ‘incurred’ ...

[72] These features suggest that Parliament did not intend that a taxpayer would be entitled to use the financial arrangements rules as a basis for claiming deductions for interest for which the taxpayer was not liable or did not pay. The rules were intended to operate as a net regime – that is to bring to tax the amount yielded after deducting the entire economic cost from a taxpayer’s entire economic benefit. In the absence of a liability a taxpayer claiming the benefit of a deduction for interest payments would be purporting to incur that liability without suffering the economic burden. We are satisfied that the intended purview of the rules is to exclude notional transactions.

The Court concluded on this aspect of the case in this way:

[110] Mr McKay [who was counsel for the taxpayer] submits that Alesco NZ simply chose the OCN structure as one among a range of means when carrying out economically rational transactions. The company was seeking to promote the genuine commercial goal of funding the acquisition of two businesses. In this context it was free to structure the transactions to its best tax advantage. And the evidence shows that the taxation benefits were primarily Australian in character. That is because a deduction would have been available for Alesco NZ in New Zealand whether the company chose to fund the acquisitions by way of issuing notes or by incurring interest bearing debt.

[111] Mr McKay says that Alesco NZ’s choice of the OCNs had an underlying commercial rationale. The company adopted this structure as a mechanism to fund existing financial obligations. This feature contrasts with other tax avoidance cases where the transactions would not have been entered into but for the tax benefits to be achieved. Alesco NZ’s acquisitions were not driven by tax considerations. The OCNs were an intermediate step along a pre-ordained commercial path.

[112] However, this distinctive factor does not protect Alesco NZ. The question is whether the particular arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance. A structure whereby the parent provided funding to its subsidiary of \$78m for 10 years on an interest free basis, in exchange for the subsidiary issuing to it optional convertible

⁸¹ References omitted.

notes, cannot possibly have been chosen for a predominantly commercial purpose. Mr McKay has not identified one, and nor could he.

[113] There is only one available inference: Alesco NZ adopted the OCNs solely in pursuit of the goal of tax avoidance, to obtain a taxation benefit whereby the advantage of interest deductions was totally disproportionate to the economic burden. The benefit did not naturally attach to or was not subordinate or subsidiary to an identifiable concurrent commercial purpose or effect. Nor was the benefit merely incidental to an underlying commercial purpose or effect; it was the only identifiable purpose and effect of adopting the OCN structure. We are satisfied that, but for that benefit, the OCN structure would not have been chosen.

XIII ANOTHER APPROACH

Critical to the approaches taken in the cases to date has been the understanding that the GAAR operates to avoid tax arrangements which, but for the invocation of the GAAR, would be effective. The twilight zone to which I have referred⁸² is premised on this understanding.

As noted above,⁸³ in *Ben Nevis* the Chief Justice and Anderson J were reluctant to accept that there is a twilight zone of the kind postulated:⁸⁴

[2] We write separately to express reservations on aspects of the reasoning adopted by Tipping, McGrath and Gault JJ, not essential to their conclusions on the application of s BG 1 and the consequences. We differ from them in being of the view that the specific statutory allowances under the Income Tax Act are not in potential conflict with the general anti-avoidance provision and that the two do not need reconciliation. Rather, both are to be purposively and contextually interpreted If the use of a specific provision falls outside its intended scope in the scheme of the Act, the use is not authorised within the meaning of the specific provision. ... On this view, we do not think that there are stark differences between the general approach to statutory interpretation of specific tax provisions in New Zealand and in the United Kingdom ...

...

[4] In a fiscal statute the terms and concepts used may, depending on purpose and context, be used in a business or accounting sense. It would be wrong to start with any preconception that 'ordinary meaning' or 'legal meaning' is to be preferred to the meaning a term has in business or accounting. Similarly, where the substance of an arrangement needs to be gauged in application of the provision of a tax statute, a purposive construction of the provision may indicate that it is legal substance which is in issue or it may indicate that the statute is concerned with business substance. The provisions of a tax statute apply to many different

⁸² Part II, text near footnote 10.

⁸³ In Part II, text near footnotes 11 and 12.

⁸⁴ *Ben Nevis*, above n 10 (references omitted). The quoted text as to the 'critical question' in [5] of the passage reproduced here is from *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684 at [32] per Lord Nicholls; while the *Ramsay* decision referred to in the same paragraph is *WT Ramsay Ltd v Inland Revenue Commissioners* [1979] 1 WLR 974, 975 (CA), discussed by Lord Templeman (see Part VIII above, text near footnote 57).

financial structures. It may use, according to the context, legal, commercial or accounting terminology ...

[5] The meaning of any term used by the statute in a particular provision must be contextually accurate. We do not therefore accept that when considering the application of a specific tax provision, and before considering the question of avoidance, the Court is concerned primarily with the legal structures and obligations created by the parties, and not with the economic substance of what they do. It depends on the context. The critical question is whether 'the relevant provision of the statute, upon its true construction, applies to the facts as found'. Those facts must be viewed 'realistically' because, as Lord Wilberforce put it in *Ramsay*, tax is 'created to operate in the real world, not that of make-believe' ...

[6] The taxpayers here had claimed allowances in respect of amortisation of a licence fee for use of land for forestry purposes and in respect of premiums for insurance against the risk that the forest would not yield a specified return. It is not necessary in the present case to determine whether these claims were properly made under the specific provisions of the Income Tax Act ...

What is proposed looks like the fiscal nullity approach, albeit one which is GAAR-enhanced. I have set out what was said because I suspect that it reflected discomfort on the part of the judges concerned with the parliamentary contemplation test. That test, however, was adopted in the majority judgment in *Ben Nevis* and in the unanimous judgment in *Penny and Hooper v Commissioner of Inland Revenue*.

XIV A FINAL WORD – FOR NOW

As I have endeavoured to explain, the parliamentary contemplation test was largely premised on the judgment of Lord Templeman in *Challenge*. So it is not devoid of support in the earlier authorities. It enables the courts to grapple directly with what most would see as objectionable about tax avoidance. That it is not obviously reconcilable with conventional scheme and purpose interpretation is a function of the view – my twilight zone view – that the relationship between the GAAR and rest of the tax system raises issues of interpretation and application which are sui generis. Perhaps most significantly, it provides a reasonably straight-forward approach to the determination of tax disputes.

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TAX AND TIME TRAVEL: LOOKING BACK AND LOOKING FORWARD – A TAX ADMINISTRATOR’S PERSPECTIVE

*Paper accompanying plenary address delivered at ATTA 2016**

JAN FARRELL

Time present and time past
Are both perhaps present in time future,
And time future contained in time past.¹

I INTRODUCTION

Historians often refer to the mistakes of the past as lessons for future actions. This paper addresses some significant events of past tax administrations and what we might expect looking forward.

More than ever, tax regulators are being called to account to demonstrate a robust stewardship of their tax systems and to ensure that revenue collection is broadly commensurate with economic activity and headline rates of tax. Political exuberance against multinationals in a world where some are perceived as not paying a fair and commensurate share of country tax has taken control of many policy agendas. Understanding the drivers and extent of such emerging practices will not only assist present strategic goals, it will shape the future tax system. It follows that decisions made by tax administrators on interpretation issues or concessions in areas of the tax law, or in relation to the handling of tax risks, can directly affect federal tax receipts well into the next decade.

This article addresses past events, present challenges and what the future might bring from a tax administration perspective.

II ROLE OF A REGULATOR LIKE THE AUSTRALIAN TAXATION OFFICE (ATO)

The ultimate litmus test of whether ideas worked well is whether they stood the test of time by serving government and the community as envisaged. Changes in the law that are judged harshly at the time may, with the benefit of hindsight, be understood as a good solution that was just too unpalatable for immediate implementation. A change in attitudes, some time further down the track, might allowing the concept to be (re)introduced. History recalls the

* The views expressed are a reflection of my experience working in many areas in the Australian Taxation Office (ATO) which included the role of Deputy Commissioner, Case Leader for the Public Groups and International Business Line. They are personal views based on my experience in tax administration.

¹ T S Eliot. *The Four Quartets*. From the opening lines of Quartet No1: *Burnt Norton*. Collected poems 1909–35 (1936) Faber & Faber.

attempt, back in the mid-1980s, to proceed with a sensible tax proposal for an Australia Card, where every citizen had a unique identifier known to all government departments.² This was an idea the community was not ready to embrace, and tax file numbers won the day; but we may yet see a unique identifier applied for wider social security purposes in the future. More recently in Australia we saw polarised opinions about new measures for a mining resource rent tax and a carbon tax. The very suggestion of new or increased taxes is enough to put politicians (all around the world) in hot water.³ The notion of 'formulary apportionment' of global income to ensure countries received their fair share of tax from cross-border transactions was also kicked around for a long time and is yet another concept that didn't find common appeal.

The strategic role of government revenue agencies is ultimately to provide a service to the public by effectively managing and shaping the Commonwealth tax and superannuation systems, to benefit all Australians – so it is a valued part of the community fabric.⁴ The ATO must be seen to act in a consistent and impartial manner and be subject to a balance of internal governance and external oversight to answer questions on our transparency and accountability for management of the tax system.

The record of the ATO on its primary function as the government's principal revenue collection agency stands for itself. Back in 1975–76 then-Commissioner Sir Edward Cain, CBE, reported net revenue collections of \$13.47b.⁵ By contrast, Commissioner Chris Jordan, AO, reported in the 2014–15 Annual Report total collections of \$336.8b – an almost 25-fold increase, albeit on a narrower tax base, and just ahead of nominal GDP growth over the same period, which had a 20-fold increase.⁶ Staff numbers also steadily increased over time to administer a changed mix of taxes; from the 1970s base of around 11,800 overall staff operating largely under state-based Deputy Commissioners to around 21,300 nationally based staff, over more dispersed locations.

² The Australia Card was proposed in 1986 as a national identity card. It responded to concerns about wide scale tax evasion, but did not gain popular public support because of privacy concerns. The legislation to introduce the card had already been rejected twice in the hostile Senate and it provided the trigger for the double dissolution of both houses, which led to the 1987 election in July, and a later decision of the new Government which was not to proceed with the Australia Card.

³ In an acceptance speech for the Grand Old Party (GOP) nomination in New Orleans at the Republican National Convention in 1988, the then presidential candidate George H W Bush famously said 'Read my lips: no new taxes'. This apparent commitment to voters was broken in a budget agreement in 1990 when defence spending escalated and the national budget deficit rose so taxes were increased in some areas. The current President elect has a different agenda for reduced tax rates that seems to have found common appeal for companies.

⁴ This aligns to a vision to be a leading tax administration known for its contemporary service, expertise and integrity. Back in the early 1990s, the Commissioner of Taxation, *Annual Report 1991–92*, Commissioner Overview at 3, published under the administration of then Commissioner T P Boucher, had the theme of working 'Towards a World Class Tax Administration', which remarked on new work underway to revitalise 'Australian tax administration'.

⁵ The Commissioner of Taxation, *Annual Report 1975–76*, at 18 lists total revenue of \$13.47b. The tax base at that time included estate duty, gift duty, sales tax, as well as levies for tobacco, wool, the stevedoring industry and fruit canning. The Health Insurance Levy had only just been introduced by *Income Tax Assessment Act 1976* at a basis rate of 2.5% for resident individuals so for the 1976–77 year three quarters of the basic rate applied, namely, 1.875%. The general company tax rate was 42.5%.

⁶ Nominal gross domestic product (GDP) in 1975–76 was \$83,150m and in 2014–15 it was \$1,609,992m, amounting to almost a twenty-fold increase. This assumes that taxation revenue is principally driven by movements in nominal income and at an aggregate level nominal GDP (I) is a proxy for national income.

There has been interest from time to time in estimating trends in ‘tax gaps’⁷ for the reason that the tax gap represents one high-level macro indicator of what has been lost. While generally sound, these indicators suffer from some inherent difficulties, given that they are based on estimates, assumptions and uncertainties. The initial tax gap measures may not be entirely robust benchmarks, especially as the range of accessible data sources improves to reduce uncertainty (for example by determining precise levels of non-detection of tax risks) and as assumptions are discarded and replaced by hard evidence. Notwithstanding such improved knowledge about the causes of the compliance gap, the absolute estimates may *increase* over time if it transpires that the basic approach has a conservative bias. What all this means is that we should expect in the future to improve on past efforts, but the outcome of improvements may not always be measured numerically.

A blueprint for a modern tax administration to be efficient and effective suggests some desirable features including adequate (operational) autonomy and adequate resources together with a stable legal framework (for assessment collection and enforcement) so that it can adequately respond to changing circumstances but is also accountable for its actions and subject to control and assessment.⁸

From time to time the ATO has been given various other roles outside traditional revenue collection, and it has necessarily shifted its focus to augment welfare delivery of government initiatives; so at various times the Commissioner of the day also had other hats to wear as the Child Support Registrar, the Development Allowance Authority, and (still) the Australian Business Registrar.⁹ Many of these initiatives set new administrative challenges for the ATO. Equally, they recognised the ATO as being capable of implementation of new functions that supported economic growth or collected payments on behalf of other agencies. Notwithstanding their eventual cessation or transition out of the agency, the effect has been to place greater demands on the ATO workforce, which has evolved and adapted to each challenge.

⁷ The compliance ‘tax gap’ is, broadly, the difference between taxes actually paid and what should have been paid if every entity or individual or remitter was fully compliant with their tax obligations. The related term ‘policy gap’ refers to tax foregone due to tax concessions that are part of the body of law (also called tax expenditures), especially those provisions that may be used to lower the tax levied or may operate to augment base erosion and profit-shifting to non-tax or low-tax jurisdictions.

⁸ European Commission report *Fiscal Blueprints – a path to a robust, modern and efficient tax administration* (European Communities 2007) 13–16. Also refer to the OECD report, *Tax Administration 2015, Comparative Information on OECD and other Advanced and Emerging Economies* (August 11, 2015) 23–6.

⁹ Under the *Child Support Act 1988* the Commissioner of Taxation became responsible for collection of child or spouse maintenance payments due under the Child Support Scheme until ten years later when it was sufficiently established to move out to the Department of Family and Community Services. Responsibility for the Development Allowance Authority, established in 1992, was also given to the Commissioner (or his delegates) as a statutory office holder responsible for management of tax incentive allowances under the *Development Allowance Authority Act 1992* for concessions that were designed to improve international competitiveness through ‘microeconomic reform’ for genuine private sector investment. There were two incentive schemes, the development allowance and the infrastructure borrowings tax offset scheme. However the initial incentives were terminated for new cases by the *Taxation Laws Amendment (Infrastructure Borrowings) Act 1997* as the concession gave rise to unintended consequences and cost estimates (1993–2003) grew from \$100m to \$1.5b. Lastly the maintenance responsibility for the Australian Business Register accompanied the Australian Business Number single identifier that government introduced on 1 July 1999 as part of Government measures for a new tax system where some 2.8m requests for registration were received in that tax year.

The management of superannuation has been a significant concern for the ATO along with its partner agencies from the first appearance of superannuation funds in the tax law in the early 1960s.¹⁰ Then, it consisted of fairly rudimentary retirement vehicles. The more modern reforms have reacted to studies on our aging population and associated welfare burden. The superannuation industry controls a significant portion of the nation's investment,¹¹ and is too big to ignore. Complexity has emerged through a widening of policy and the imposition of compulsory employer superannuation support for employees (in the superannuation guarantee regime) and the current waves of employees' retirement savings held in SMSF vehicles. The demands on government, to encourage people to self-fund for their retirement and to decrease reliance on the public purse, are not likely to wane into the near future, given the bipartisan desire to reduce public debt.

III TAX ADMINISTRATION THEN AND NOW

The institution of the ATO is now 105 years old¹² and I don't plan to look back that far, although this history does present the seeds of many present initiatives, and no doubt some future ones.

A ATO Employee Experience

I commenced employment in the ATO in the somewhat myopic days of full ATO assessment, when the ATO manually checked information supplied in detailed paper tax returns. The workloads consisted of high-volume processing and 'technical scrutiny' of claims against taxable income. We coded the returns using alpha codes for a limited range of adjustments, and this was sent to data entry points which produced machine-generated advice notes issuing to taxpayers with their notices of assessment. Apart from the audit section, we had very limited personal contact with taxpayers, at either assessment or review stage, unless it was our role to review assessing action after lodgment of an objection in order to settle claims, based on a new opinion of the adequacy of evidence.

The lexicon we used last century included ATO buzzwords like 'Chief Assessor directives' and 'Canberra Income Tax Circular Memorandums' (CITCM) – a form of internally binding ruling – and it was an age when tax enquiry counters distributed verbal tax advice.

¹⁰ See the majority judgment of Stone and Allsop JJ in *Cameron Brae Pty Ltd v FCT*, 2007 ATC 4936 at 4945, [2007] FCAFC 135 where the legislative history of superannuation (in the context of s 82AAE) is recounted, noting the first appearance of superannuation as follows:

'[29] The first definition of the phrase 'superannuation fund' in the tax legislation appeared in the 1961 Act by the insertion of s 121B into the Tax Act...[and]...was variously amended.' The *Income Tax Assessment Act 1936* (Cth) introduced the present s 6(1) definition of a superannuation fund to mean (in part) '(a) a scheme for the payment of superannuation benefits'.

¹¹ Australian Bureau of Statistics, *Managed Funds, Australia*, September 2015, reported that the managed funds industry had \$2,590.6b under management.

¹² The First Annual Report was by the Commissioner of Land Tax in 1912, relating to the operations of the Federal Land Tax Department in the first year of existence (1910–11) and provided to Parliament by the then Treasurer of the Commonwealth, The Right Honorable Andrew Fisher. Of note, under the heading 'Evasion of the Act', at 11, it is stated: 'It may be fairly stated that, so far as the investigations of the Department have yet disclosed, the cases of deliberate breach or evasion are few in number.' Non-lodgements, debt collection activity, objections and appeals all get coverage.

We worked in large, breezy, open-plan offices without air conditioning or partitions, with one group telephone for half the floor area and a working day tabulated by time clock (Bundy Cards) for each employee, and a rattly tea trolley to herald the morning and afternoon work breaks. There was no capital gains tax, no goods and services tax, no fringe benefits tax, no comprehensive thin capitalisation rules and no taxation of financial instruments regime or a tax consolidation regime, so the interaction problems we now experience in the tax legislation were limited. In fact, a lot of time was spent on defining and refining the basics of tax law – the ambit of income, deductions, rebates and concessions. Those were the days of targets to achieve daily output tallies, with limited time for technical scrutiny and with machine-like turnover of file stock of salary and wage, partnership, trust, and to a lesser extent company and superannuation returns.

The ATO has more recently focused on the employee experience and capability improvements through knowledge sharing, updating workplace infrastructure to create an agile work environment of virtual desktop platforms. This is designed to create a smarter and adaptable workforce. The pace of technology innovation has allowed government an enhanced ability to use technology to drive efficiencies, as we moved away from typing pools of dedicated people on typewriters and towards a computer on every desk. Twenty-five years ago our ‘aim was that... 30 per cent of staff would have access to business tools to meet the needs of the office of the future.’¹³ The present ATO Executive might justifiably be able to trumpet that they have well surpassed that objective.

B Attitudes to Tax Administration

ATO attitudes to administration have certainly evolved over time – from early times of ‘protecting the revenue’, to a more efficient and effective operation that ensures taxpayers’ willing participation in the tax system through payment of the right amount of tax at the right time, thereby building community confidence.¹⁴

With the introduction of *The Freedom of Information Act 1982* (Cth), a greater environment of openness came to Australian Public Service agencies, and the ATO published many internal guidance notes to make them generally available, as well as making other material gathered under its formal powers available on request. Almost a decade earlier, in the mid-1970s, the Commissioner’s Annual Report had its own version of a release of (internal) information detailing the people who had an ‘understatement of taxable income’ during the year, including names, suburb of residential address (or town) of individuals and occupation/business of all individuals and companies and the amount of that understatement, together with the amount of penalty imposed, for the relevant years.¹⁵

If a sign of a mature tax system is the sophistication of its risk and collection mechanisms, then it might well be expected that both mechanisms will continue to feature on the improvement continuum into the future.

Risk detection mechanisms that were used at the turn of this century in Australian tax administration relied heavily on data matching, with intelligence from both audits and

¹³ Commissioner of Taxation, *Annual Report 1991–92*, 138, ‘Goal: Staff finding the ATO a satisfying place to work: Business Tools Objective’.

¹⁴ ATO Program Blue Print Summary 2015 <<http://reinventing.ato.gov.au/program-blueprint-summary>>.

¹⁵ See Commissioner of Taxation, *Annual Reports of 1974–75 and 1975–76*: Schedule 1 ‘Breaches and Evasions’.

provision of advice, as well as community contacts, research initiatives and a newly formed Analytics Project.¹⁶ The ATO's risk systems were somewhat rudimentary in the 1980s, just at the time foreign banks were given licences to operate in Australia. Rather than management-initiated audits, specialist in-house economists were employed to look at the tax performance of various sub-segments of large and medium companies operating in Australia, and those that displayed signs of low or no profit margins came onto the ATO's radar. Also of interest to the ATO were innovative financial instruments, the substance of which were not well understood in the ATO at that time. An attempt to access information not freely made available to the ATO on particular financial arrangements was discussed in an often-cited court case in which the ATO auditors had carried out an 'unannounced visit' on Citibank's premises to seek information using the Commissioner's general access power.¹⁷ The courts properly pointed out the need for due process in seeking broad access and allowing claims for legal professional privilege to be made.

The ATO does indeed acknowledge the right of taxpayers to make claims for legal professional privilege, and also allows an opportunity to make a claim for the accountants' concession.¹⁸ Occasionally, in my experience, we have found that broad claims to exclude access to tranches of documents on the basis of alleged privilege are capable of stopping difficult audits in their tracks, and the ATO is at pains to make sure that such claims are asserted only where they properly apply. In the instructive words of Lord Justice Hamilton:

Claiming privilege in an affidavit of documents is not like pronouncing a spell, which, once uttered, makes all the documents taboo.¹⁹

IV THE ADVENT OF SELF-ASSESSMENT AND RULINGS

What sparked one of the most significant changes to tax administration was undoubtedly the introduction of the self-assessment system on 1 July 1986.²⁰ In this new world of self-assessment, income tax returns were no longer technically scrutinised by income tax assessors. Rather, tax returns were input directly into the data warehouse repository and the ATO shifted emphasis to post-assessment audit and 'compliance improvement activities'.²¹ Development of sophisticated risk systems that tapped into a suite of meta-data to drive compliance plans was inconceivable at that time, as was the notion of the ATO providing electronic pre-filled information on personal tax returns.

¹⁶ Commissioner of Taxation, *Annual Report 2002-03*, 70-71 (Michael Carmody).

¹⁷ *FCT & Ors v Citibank Ltd* 89 ATC 4268.

¹⁸ In November 1989, the ATO granted a concession to clients of professional accounting advisors which allowed such advisors to withhold, in the absence of exceptional circumstances, certain documents from the ATO.

¹⁹ *Birmingham and Midland Motor Omnibus Company Ltd v London and North Western Railway Company* [1913] 3 KB 850 at 859.

²⁰ See House of Representatives Hansard, 63, Treasurer Paul Keating, 2nd reading of Appropriation Bill No1 1985-86 on 20 August 1985: 'The Government has also approved the implementation of a system of self-assessment by taxpayers to be introduced from 1 July 1986. This will greatly increase the capacity of the Tax Office to concentrate its efforts on the main areas of avoidance and evasion and increase efficiency in processing tax returns.'

²¹ Address by Michael D'Ascenzo (then Acting First Assistant Commissioner of Taxation) to the National Convention of the Taxation Institute of Australia on 9 May 1993 at 2.

The internal review that made traditional assessing production work redundant found simply that changes were needed in the face of the:

1. 'costs associated to assess business and company returns';
2. insufficient detection and treatment of general non-compliance with tax obligations; and
3. 'lack of job satisfaction for staff'.

At the time, various stakeholder associations were involved and it was heralded as a new age of consultation and openness by the ATO – which a former Commissioner referenced as allowing the ATO to put 'past enmities aside' – akin to the Berlin wall coming down, and through such co-operation, building 'a modern tax administration, world class.'²²

In fact the tax profession, in that decade and since, has been heavily involved in consultation on many novel movements in tax legislation stemming from numerous legislative amendments coming from the Tax Law Improvement Project that introduced the 1997 Act along with some new measures,²³ and the mandatory Regulation Impact Statements that came into being to estimate impacts of proposals affecting business.²⁴ In the 2000s, the integrity of the tax system was sought to be improved by a new consolidations regime,²⁵ among other changes, the biggest being the abolition of sales tax and the introduction of a goods and services tax on 1 July 2000.

Consultation emerged as a key plank in the modus operandi of Treasury, the Board of Taxation and the ATO. Notwithstanding its undoubted benefits, the growth of various levels of consultation may perhaps have been over-enthusiastically adopted in the ATO.²⁶ A recent review of ATO industry, professional and community consultation committees under the ATO Reinvention banner noted duplication and attendant resourcing issues, and the decision was made to reduce them from 68 to 8, and reduce the number of internal committees from 45 to 22, with special-purpose and technical forums convened as required.²⁷

²² Ibid. Footnote 10 at 8, citing the (then) Commissioner T B Boucher's statement to the Joint Public Accounts Committee of 29 May 1992.

²³ The new *Income Tax Assessment Act 1997* was written to make the law more understandable and principle based. Also in the 1990s we saw *Taxation of Financial Arrangements* Consultation document (December 1993) followed by an Issues paper in 1996 etc. (until legislation emerged), the redrafting of the *Thin Capitalisation* provisions in TLAB (No 4) 1997, the introduction of *Controlled Foreign Companies* rules (1990) to tax foreign source income of Australian residents and extending Part IVA to include withholding tax avoidance (per s 177CA in the 1996–97 income year).

²⁴ This followed the government's Regulation Review and was part of, 'More Time for Business' 24 March 1997 by the Hon John Howard.

²⁵ Per various *New Business Tax System Bills* in 2002. Other highlights included the Simplified Tax System for small business; the Australian Business Number became our single business identifier; the PAYGI system replaced provisional tax, prescribed payments, company instalments and withholding tax; and let's not forget company headline tax rates plummeted from 36% to 34% in 2000–01 and then to 30% for 2001–02.

²⁶ See the Report of the Commissioner of Taxation 2008–09, where the three Cs were embraced – consultation, collaboration and co-design.

²⁷ Geoff Leeper, then Second Commissioner, People, Systems and Services, Address to the National Tax Practitioner Conference, Sydney, Wednesday, 18 June 2014 said that 'a considerable amount of time was invested in the old arrangements, with almost 1,500 external people participating in 230 meetings

While core issues should invariably benefit from consultation, the future may not lie in committee-driven consultation but in more interactive, real-time management and intelligence gathering where collective knowledge sharing takes place.

The Self-Assessment Priority Tasks Project (1991) made recommendations that also led to a new system of binding public rulings and binding private rulings, along with new systems for penalty and interest, although the freedom of information changes had started off an earlier internal rulings process.²⁸

The ATO's Public Rulings guidance is a key service that publishes ATO technical interpretations. It came of age with notifications by way of the Commonwealth Gazette, and a panel of professional tax experts at the review and clearance stage to bring in commercial acumen and independent views. The initial, untracked/unnumbered issuance of private binding rulings matured considerably after implementation of quality standards and improvements recommended after several substantial reviews.²⁹ Guidance through the provision of ATO views continues to be a hallmark of its service, and it assists voluntary compliance.

V ASSISTANCE TO TAXPAYERS, AND COMMUNITY EXPECTATIONS

In our current environment, individual taxpayers enjoy the benefit of pre-filled electronic tax returns, populated with financial institution data, dividend data, employer information and other benefit information using the downloadable e-Tax module and the newer web-based myTax. The ATO is part of myGov, which now has more than 4.3m linked clients, as a single point of entry for government service. The ATO is moving to a future that has a digital interface platform, needing very little taxpayer effort to supply information or prepare documentation in many cases, especially for workers on a lower income.

I can recall a time in 2004 when I was responsible for management of the Individuals business line. An officer advised me he had developed an instruction guide for any taxpayer who was in receipt of an eligible termination payment to calculate the concessional and full tax outcome. It had more than 70 steps, with all possible permutations covered. While that was indeed a very thorough approach, I asked him to have another go at more simplified instructions to cover the basics for self-preparers.

a year as part of 68 ongoing committees. This has been significantly reduced to eight stewardship committees plus project-like consultation for specific issues.' See also similar comments from Chris Jordan, Commissioner of Taxation in his address to the ATAX 11th International Tax Administration Conference, Sydney, 14 April 2014. Note the Commissioner of Taxation, *Annual Report 2014–15* which recounts that 68 matters were consulted on and completed, and 53 matters were in progress.

²⁸ A Report on Aspects of Income Tax Self-Assessment in August 2004 by Treasury further suggested improvements to the advice system, to make it more responsive including the option of a deemed negative ruling for those older than 60 days, refraining from ruling on issues not directly raised in private binding ruling (PBR) applications and shorter periods of review.

²⁹ For example, The Australian National Audit Office (ANAO) performance audit of July 2001, *The Australian Taxation Office's Administration of Taxation Rulings*, Audit Report No. 3 of 2001–2002 and the subsequent ANAO *Administration of Taxation Rulings – Follow up Audit*, Audit Report No. 7 of 2004–05, The Australian Treasury *Report on Aspects of Income Tax Self-Assessment*, August 2004, 7–25 and the more limited Inspector-General of Taxation (IGT) *Review of the Taxation Office's administration of public binding advice* in a report to the Assistant Treasurer of 7 April 2009; and an IGT report, *A review of potential revenue bias in private binding rulings* released on 25 February 2008.

One of the ATO's key performance indicators was the time-cost index for business and superannuation funds to prepare and complete key tax forms.³⁰ The ATO started very limited qualitative work on the costs of compliance for small business back in 1991 by focusing on record-keeping and reporting requirements. Various trends were identified, from inadequate software availability to the burdens of sales tax. This was not unusual, since the sales tax rules had developed from a single rate tax with limited exemptions (when introduced in 1930) to a much larger suite of assessment Acts and exemptions.³¹ Then, in September and October 1995, under the Compliance Improvement banner in conjunction with the Revenue Analysis branch, the ATO conducted wider, but limited studies,³² which revealed that the average time spent by businesses (surveyed) on tax activities per month was 18–23 hours.³³ However, the finding I most liked was that 'on average, businesses consider that they would save 94 hours per annum if federal taxation were abolished', and if allowed 'fair compensation' for their compliance costs, would claim approximately \$3,000 (outliers excluded). Yet on the upside, 'approximately half the respondents agreed that their requirements of the federal tax system improved the record keeping of their business.'

The Taxpayers' Charter marked a service shift for ATO operations on its commencement on 1 July 1997, as it applied to all taxpayers' interactions with the ATO and introduced a set of service standards against which administrative responses would be measured.³⁴ The genesis of the Charter followed a Joint Public Accounts Committee recommendation in 1993, and was in line with initiatives of some overseas tax jurisdictions in explicitly documenting expectations and commitments as to how revenue authorities would treat taxpayers and vice versa. The initiative also coincided with the Howard Government's statement that Service Charters were to apply to all government agencies that provided services to the public 'to create a more open and responsive service culture in the public sector'.³⁵ The ATO was now making a number of benchmark commitments to maintain professional excellence, and these were tracked through service standards that have been continuously maintained in governance reports against key performance measures. Levels of performance and ATO processes are aspects of tax administration that remain evergreen and will no doubt continue to be reviewed, noting that the Inspector-General of Taxation's and the work programs of the Australian National Audit Office (ANAO) feature strongly in performance reviews of the ATO.

In the same era (late December 1996) the ATO began measuring general community perceptions of its performance from individual and business taxpayers who had had contact

³⁰ Treasury Portfolio Budget Statements 2015–16: Budget related paper No 116 at 203.

³¹ The joint study with the Department of Industry, Technology and Commerce and researched by Dr Ian Wallschutzky, Associate Professor in Taxation, University of Newcastle, reviewed over 12 months, twelve small businesses, both new and well established, in Qld, Victoria and NSW.

³² Chris Evans, Katherine Ritchie, Binh Tran-Nam and Michael Walpole, UNSW, 27 November 1995, *Costs of Compliance: An Interim Report*.

³³ Brian Gibson & Ian Wallschutzky, Department of Commerce, University of Newcastle in a paper for a Tax Compliance Research Conference in Canberra in December 1993, *A Case Study Exploration of Taxation Compliance Issues in Small Business*. In the study conducted from interviews of 123 participants in the 12 months between November 1991 and 1992, time spent on tax compliance activities had increased from the 12-hour average per month and the impact was assessed at that time as 'either \$7,425 or \$16,335 depending on how opportunity cost was assessed.'

³⁴ The Joint Committee of Public Accounts recommended in their report number 326 of November 1993, that the ATO adopt a Taxpayers Charter to address a perceived imbalance of the Commissioner's wide powers for income tax collection against the rights of taxpayers.

³⁵ The Hon John Howard MP, 'More Time for Business,' 24 March 1997, 56.

with the ATO, to obtain views about its professionalism in respect of areas covered by the Charter.³⁶ The outcome was generally positive on competence and integrity, but work on ATO responsiveness and taxpayers rights continued.

Current surveys reveal positive feedback from the community on the ATO's 'perception of fairness' surveys³⁷ concerning individuals, and earlier resolution of tax disputes as alternatives to litigation was also perceived well. Technology has allowed feedback to be interactive and online, and for an ATO presence on Facebook/Twitter/You Tube – something that could not have been delivered in the past.³⁸ In addition, the Small Business Assist web page provides real-time guidance and support from an ATO officer on particular topics, and the Let's Talk Forum (discussion board) has interactive conversations with tax agents with topics like the 'digital by default initiative'. These avenues for positive engagement with the community fosters willing participation, in ways we would not have envisaged in times past. The ATO work covers both internal and external facing improvements.

VI STRUCTURE AND MODERNISATION OF THE ATO

Our brief history of the ATO records that one of the most significant decisions was to revitalise our computer capacity, to integrate it into our activities for better compliance and service initiatives and to modernise the ATO.³⁹ Typing pools where officers once took handwritten notes to be converted to type were closed, and work processes were redesigned. To transition from a processing organisation to a service-based organisation, we attended team-building workshops run in-house by senior tax officers, with a range of visitor trainers, from all walks of life, who demonstrated a broad range of skills including ethics, tactics and human resources management. This program, funded through the Public Services Commission, was a new style of manager training looking at the 'psychological and sociological problems' that may be experienced by ATO staff, which wasn't found in any rule book produced at the time.⁴⁰ In addition, a core competency model was developed to match

³⁶ Independent consultants such as Millward Brown Australia, were engaged by the ATO to initiate a process to obtain service feedback, as a way to gauge effectiveness. Around 2,000 people were randomly contacted by telephone with core questions (from 1996) and then in December 2000 a six monthly Professionalism survey was conducted using 9 characteristics expecting to achieve a 70% satisfaction rating. Regular feedback is now a feature of the modern ATO.

³⁷ Millward Brown Australia consultancy.

³⁸ Facebook – ATO page posts educational notes for different taxpayer communities to increase awareness. For example, deadlines to lodge returns, tips for small businesses – it allows the public to comment on the posts as well; You Tube – features videos on various tax and super topics including ranging from presentations by ATO officers on proposed legislative changes affecting foreign investors, through to basic educational videos on basic tax obligations targeting recent migrants. LinkedIn – promotes visibility of the ATO to the local and global professional working community. You can follow the ATO on this site to receive continual latest updates/posts and also be connected to those that are working in the organisation.

³⁹ Edmonds, Leigh, *Working for all Australians 1910–2010: A brief history of the Australian Taxation Office* ATO Canberra November 2010 at 196–206. The Modernisation Program is described in the Commissioner of Taxation, *Annual Report 1993–94*, 83–9, to have received in-principle approval from Government in 1987 for 'improving our services to the community and meeting the challenges of our changing environment toward the year 2000.'

⁴⁰ The Managing in the Nineties Program (MIN) was heavy on practical training and experiential learning and 'light on theory' and resonated well with many people who were enrolled into the Program. Its aim was to have it rolled out to 17 offices: (71st Report) Commissioner of Taxation, *Annual Report 1991–92*, 156.

employee skill sets with ATO work types, and the ATO supported a Bachelor of Taxation degree through the University of NSW (ATAX) for undergraduate degrees and from 1993 for postgraduate courses.⁴¹

In the 1990s the ATO became a new nationally run business organisation that took over from the old state-run branch offices. I found myself as a national litigation appeals manager fielding calls on cases around the country, which was quite a learning curve. Tax Law Services was set up in 1994 to provide technical leadership throughout the ATO to resolve complex technical matters in an environment where 'all technical staff could perform at their optimum'. It consisted of three arms: Legislative Services, whose primary role was policy advice and our window to government; Tax Counsel Network, which was a team of senior technical resources; and a Practice Management & Development arm, which developed technological and support tools and professional development activities. All three resulted from the government's investment in the ATO's Compliance Strategy in September 1992. The then ATO's Second Commissioner (of Law) saw that the National Tax Practice role was 'interpreting, applying, mending and/or developing the law'.⁴²

In terms of client engagement, the ATO unveiled a Compliance Pyramid that formed the subject matter of many PhD theses and research papers and provided a 'valuable framework for compliance work' in the ATO.⁴³ The ATO Compliance Model worked well to depict the levels of help and engagement warranted against levels of compliance behaviour. At the base of the pyramid, where most taxpayers converged, mutual 'Trust and Cooperation' was observed; in the middle this became 'passive' facilitation, then 'active' facilitation, until, at the top pointy end of the pyramid, a small group of high-risk taxpayers warranted 'tougher enforcement'.⁴⁴

VII TAX REFORM AND THE ATO'S CONTRIBUTION

It is fair to say that some attempts at making tax law less complex and more equitable or simpler are well documented and seem to have taken time to gestate.⁴⁵ The *Asprey Report* completed in 1975 had a central objective of broadening the tax base and lowering taxes. Sounds like a familiar theme.

The tax reform package announced in September of 1985 by then Treasurer Keating introduced across-the-board cuts in marginal tax rates, a new tax on fringe benefits and capital gains tax and the taxation of income from foreign sources, with an allowance for foreign tax already paid. Cabinet decided that it was not the right time to introduce a consumption tax, because they were advised that a 'yield from a tax on services and a major

⁴¹ Our three major training programs were the Australian Taxation Studies Program (ATAX), the Taxation Officer Development (TOD) program (eg TOD 1 competency based training for lowest graded officers was developed with the Public Sector Union) and continuing professional development. ATAX began in 1991 and by 2002 had 582 graduates, largely from the ATO.

⁴² Peter Simpson, then Second Commissioner as reported in our staff magazine, *Tax People*, 1994.

⁴³ Michael D'Ascenzo, *Y2K relationships – the ATO and you post 2000*, *Taxation in Australia*, Vol 34, No.8 February 2000, 421–30.

⁴⁴ *Ibid.*

⁴⁵ For example, the 1959 Commonwealth Committee on Taxation, chaired by Sir George Ligertwood addressed tax avoidance reform but other recommendations were not picked up until the next major reform exercise in 1972 by Justice KW Asprey and the Taxation Review Committee.

extension of the wholesale sales tax' would be insufficient to fund tax cuts to low income earners.⁴⁶

When capital gains tax was introduced from September 1985 on gains not previously taxed, it managed to generate revenue beyond Treasury expectations.⁴⁷ A number of factors contributed to this, including the growth in the global and Australian economies in that decade, the scope of the net as drafted, and the lack of concessional rates. In the early days, we had a number of interpretative and technical issues to determine, and we issued an early form of tax determination to provide quick answers to vexed issues.

The policy and non-policy initiatives stemming from reviews recommending the major initiative of a goods and services tax (GST), as well as a new PAYG system, involved large-scale reforms that meant a major overhaul of ATO systems and procedures, and which impacted on many jobs in the ATO.⁴⁸ The ensuing massive recruitment exercise, which employed 4,000 new staff to deal with the additional workload in call centres and enquiry counters, is legendary in the ATO, and such recruitment is not likely to be seen on such a significant level again.

Since the handover of law design to Treasury, the ATO has contributed ideas and opinions, especially about the administrative workability of proposed new laws. It has courageously pointed out likely impediments or flaws, and provided practical input on possible improvements to proposed changes. Its corporate plan speaks of influencing policy and law design for more certain outcomes.⁴⁹

The most comprehensive and important examination of the tax and transfer system (excluding GST and superannuation) was conducted by the Henry Review in 2008–09, at the time of the global financial crisis. It produced some enlightened ideas for a future tax system.

Beyond tax reform, large-scale tax changes traditionally bring with them an increase in implementation challenges for tax administration and present opportunities for our expert workforce.

Remarkably, though, with all the media concentration on companies' tax obligations, the tax mix – where the Commonwealth derives its (direct) revenue – has not changed significantly in 60 years. It has been observed that about 50 per cent is from personal income tax collections and (in the last decade) about 20 per cent in company income tax. However, tax

⁴⁶ Cabinet Decision No. 6513 – Tax reform. Secretary to Cabinet file note dated 12 August 1985: NAA: A13979, 6513, National Archives of Australia. Australian Government publication.

⁴⁷ National Archives of Australia, Australian Government. There were no reliable 'statistics available regarding the distributions of capital gains across income ranges in Australia' although information from Cabinet Decision No. 5629 from 12 May 1985 (at 402) suggests that early low estimates of revenue collections were derived from Canadian capital gains data (by grade of income) by chart at 405. These were later overshadowed by estimated collections of around \$300m in revenue over a 5 year period: NAA: A14039, 2865.

⁴⁸ This occurred mainly through the Tax Simplification Taskforce in 1990, the Review of Business Taxation Report in 1999 (Ralph Report) and the *A New Tax System* (ANTS). There was also an 8 person 'New Tax System Advisory Board' established in July 1999 by the Treasurer to assist with effective implementation, to minimise transitional issues and to advise government about assistance to business and community sectors.

⁴⁹ When the ATO sees weaknesses in the tax law it advises government and occasionally this process of advice and subsequent public announcement has not worked as well as intended, for example where a stockpile of proposed legislative improvements is not enacted.

reform does bring changes within tax bases.⁵⁰ Leaving aside indirect taxes, it is hard to see the incidence and reliance on personal tax changing much in the future, as the world trend statistics show continuing stability in individual income tax and indirect tax as a steady source of revenue.⁵¹

Tax reform is a perennial topic for academics, the business community and indeed government. The big projects have been difficult to bring to fruition unscathed, and greater success is sometimes found in targeted reforms – notwithstanding the exceptional predicaments, trade-offs and carve-outs that can arise to adversely impact on an effective design for new taxes, for example the Mining Resource Rent Tax and Carbon Tax.

Clearly taxation concessions should assist the growth of businesses in their establishment and early stages, and once they are mature concessions should be stemmed and a fair share of tax paid by back to the community that is buying the goods and services of the business, or allowing exploitation of resources in our country. The challenge of balancing the system for greater simplicity, equity and clarity is ongoing.

VIII SCHEMES THAT FRUSTRATED THE BEST TAX ADMINISTRATORS AND ONGOING CHALLENGING AREAS

A *Frustrating Schemes of the Past*

The ATO's investigation of tax avoidance activities in the late 1970s to early 1980s grew well beyond its ability and the extent of taxpayer involvement took everyone by surprise, such that ATO resourcing barely kept pace with the monster.

The Annual Reports of the Commissioner to Parliament recount the frustration of the Australian tax administration at trying to address and understand the 'new and ingenious misuse of tax provisions' which was exacerbated by the use of 'evasive tactics' to frustrate ATO investigative action and featured 'deliberately concealing the facts' and 'making claims based on fictitious transactions'.⁵²

It is still at times extremely difficult to get the full facts necessary to properly determine tax risks, and to the extent that asymmetric information flows arise that inhibit parties from arriving at good decision making, it creates delays. It is important that tax administrations

⁵⁰ M Stewart, A Moore, P Whiteford and R Q Grafton, A Stocktake of the Tax System and Directions for Reform – 5 years after the Henry Review, February 2015, Tax and Transfer Policy Institute, Crawford School of Public Policy Paper, Australian National University at 30 and Chart 3.4 *Composition of the Commonwealth Tax System since 1950 (to 2012)*.

⁵¹ OECD *Revenue Statistics* report 2015, summary *press release 03/12/2015*: 'Corporate tax revenues have been falling across OECD countries since the global economic crisis, putting greater pressure on individual taxpayers to ensure that governments meet financing requirements, according to new data from the OECD's annual Revenue Statistics publication. Average revenues from corporate incomes and gains fell from 3.6% to 2.8% of gross domestic product (GDP) over the 2007–14 period. Revenues from individual income tax grew from 8.8% to 8.9% and VAT revenues grew from 6.5% to 6.8% over the same period'. Hence the concentration of the topic at the G20 country group and evolution of the Base Erosion and Profit Shifting Project to review some international mismatched tax law that allows corporate profits to be shifted or eliminated.

⁵² 59th Report of the Commissioner of Taxation 1979–80: *Management, Organization, Compliance and Personnel* at 4 and *Tax Avoidance* at 7.

improve the transparency of transactions that involve worldwide financial flows, related-party dealings and the taxation implications of global arrangements.⁵³

A popular method of avoidance of taxation that proliferated from the 1970s was stripping companies of their assets (or pre-tax profits) prior to their tax liabilities being paid. This was described as an 'alarming tactic' because it was compounded by an attendant lack of provision in the company's (bank) accounts for any (subsequent) tax payments that may be assessed; it was regarded as tax evasion pure and simple.⁵⁴ In response, the Commonwealth Parliament passed a number of related Acts in 1982, the most important of which was the *Taxation (Unpaid Company Tax) Assessment Act 1982*, which sought to recover evaded taxes under the *Crimes (Taxation Offences) Act 1980*. The ATO ultimately issued many notices to former owners or vendor shareholders for recoupment of tax where it was thought they were bona fide owners/directors of companies, but some found their way into the 'bottom of the harbour' repository of the criminally inclined. The tax evasion was very bold, blatant and a serious threat to the equity and fairness of the tax system, such that the remedial legislation was given a retrospective application (to all schemes uncovered that were 'practised on a wide scale entered into on or after 1 January 1972'), and the law excluded judicial review as to the assessment of the recoupment tax under the *Administrative Decisions (Judicial Review) Act 1977*.⁵⁵

Famously, an opponent of that legislation was Senator Don Chipp – who, speaking against the bill in the Senate, said:

Good heavens; give politicians the chance to legislate retrospectively and we will open a Pandora's box. I find that quite frightening. On this occasion a Pandora's box is opened in the excuse of catching the filthy people who cheat on tax. It is done for a noble purpose, one might say, and I agree. But I have never been one to subscribe to the view that the end justifies the means. That sort of proposition leads one down a track which is fraught with disaster. That is the track that Adolf Hitler went down. It is the track that every tyrant in history has gone down; that is, to make illegal today something which was legal last year.⁵⁶

Notwithstanding Senator Chipp's colourful remarks on the introduction of retrospective legislation,⁵⁷ it can be justified to ensure consistency of treatment to all participants (not the fewer late entrants). The era marked a change in the way the ATO handled large tranches of work, and in its awareness of the extent of evasion practices. The retrospectivity issue will

⁵³ The Senate Enquiry Reference Committee – enquiry into corporate tax avoidance Interim Report of 2015, has made specific recommendations to deal with Multinationals.

⁵⁴ Ibid.

⁵⁵ Explanatory Memorandum, *Taxation (Unpaid Company Tax) Assessment Bill 1982*, Part I. Treasurer Hon John Howard.

⁵⁶ See *Senate Hansard*, 19 November 1982 at 2,592.

⁵⁷ Senate Standing Order 30 also addresses retrospective bills in the tax context, by stating that if they are not introduced within 6 months of announcement then the commencement date will be after introduction of legislation into Parliament – effectively when the bill is made public. Treasury reviewed this aspect in August 2004 in their *Report on Aspects of Income Tax Self-Assessment* and concluded that retrospective start dates are appropriate to correct an unintended consequence, to address a tax avoidance issue or to correct an undesirable behavioural change on a measure-by-measure basis.

surely be a feature of legislative change and tax administration at some future time to ensure transactions falling within the same class being treated consistently.⁵⁸

Our internal history records that by 1983, the ATO had successfully employed another 580 staff⁵⁹ to strengthen overall compliance activities, and with the retirement of Chief Justice Barwick from the High Court the ATO was again successful in a tax avoidance case.⁶⁰ The waxing and waning of contentious issues in litigated tax cases will no doubt be another feature of a tax system where significant issues emerge to present uncertainty.

B Frustrations of the More Recent Past

The High Court informed us, in judgments on several test cases which the ATO considered amounted to avoidance of tax under the former s 260, that the general anti-avoidance law didn't work – because, evidently, the taxpayer had a choice of tax-effective arrangements and the ATO was not permitted to reconstruct the arrangement to produce a different tax effect. The age of tax avoidance annihilation under s 260 was replaced by the age of Part IVA. The changed law allowed an objective view of a particular arrangement and its surrounding circumstances, and included countering the then-prominent dividend stripping schemes which purported to replace otherwise taxable profits into the hands of shareholders in a tax free form.

It was not until about 1997 that the ATO commenced work on what became known as 'mass marketed schemes', after it became aware of how pervasive they had become and how innovative the arrangements were. Many aggressive promoters had made fees from targeting ordinary Australians such as miners in Kalgoorlie, to claim large deductions for arrangements that created tax benefits. These included schemes related to afforestation, agriculture, franchises, employee benefit and films, where large tax refunds were promised for very little equity outlay and non-recourse loans supposedly funded by future revenue flows. It was all too good to be true, quite uncommercial in nature, and certainly ineffective under the tax law.⁶¹

⁵⁸ Note the Full Federal Court decision in *IOOF Holdings Ltd v FCT & Anor* [2014] FCAFC 91, an appeal from a private ruling challenging whether it was entitled to deductions for rights to future income (RTFI) in respect to shares in Australian Wealth Management, where it was held that there was no 'accrued right' to have the matter determined according to the law that existed before the Consolidation provisions were amended to remove the deduction for RTFI, in Tax Laws Amendment (2012 Measures No.2) Act 2012.

⁵⁹ Leigh Edmonds, *Working for all Australians 1910–2010: A Brief History of the Australian Taxation Office*, 172–3. See also the 59th Report of the Commissioner of Taxation 1979–80 where at 4 the Public Service Board approved an addition of 400 staff to the staff ceiling for that year and 180 in the following year.

⁶⁰ The High Court refused special leave to appeal against the Full Federal Court case of *Leary v FCT* 80 ATC 4438, where counsel for the taxpayer had argued before the Full Federal Court that notwithstanding a material advantage had been obtained by the taxpayer paying \$10,000 to the Order of St John, the taxpayer should not be deprived of a gift deduction. At the time, this was a significant case for the Commissioner to win.

⁶¹ The ATO applied the general anti avoidance provisions to many schemes, a Senate enquiry was conducted and the Ombudsman investigated the Budplan arrangements after investor complaints and for the benefit of 'affected investors, tax advisers and financial planners'. Refer to the publicly released reports of the Commonwealth Ombudsman under s 35A of *Ombudsman Act 1976*: '*The ATO and Budplan*' of June 1999; and '*ATO and Main Camp; Report into the investigation into the ATO's handling of claims for tax deductions by investors in mass-marketed tax effective schemes known as Main Camp*'. Recommendations were adopted by the ATO and some legislative measures were also introduced such as a limit on prepayments related to tax shelters.

By 30 June 2001, the ATO had finalised its views on 176 investment schemes involving some 40,000 taxpayers caught up in one or more of the arrangements.⁶² The administrative reaction to the issues was, once understood, to reduce the interest rate on debts, start a print advertising campaign with warnings and fact sheets, and look at dispute resolution mechanisms. I was part of the widely held settlement panel that approved terms of settlement offered to individual investors on some arrangements to resolve disputes, and guidelines were posted on our website.

Had the ATO been able to detect and comprehend some early warning signs, or had there been systematic intelligence signalling material changes to high-risk refunds or instalment variation patterns as they were occurring – then the acknowledged slow administrative responses to the extensive risks may have permitted real-time assessments. Today's Smarter Data initiatives are designed to assist with risk patterns, but back then we used Product Rulings, introduced in June 1998 to create an avenue to advise our views at the early stages of prospectus-based offerings, to allow arrangers and prospective investors some certainty. Most of the litigation challenges by promoters to these arrangements found the ATO ultimately successful.⁶³

This dark era of aggressive tax planning led to the Commissioner releasing Taxpayer Alerts or early warnings about the administrative treatment of tax schemes that we had encountered and were likely to take action against. More comprehensively, the ATO shifted its focus to promoters and deterrence of this behaviour; hence a decision had to be made whether to bring in a taxpayer disclosure system for participants in an (identified) tax scheme, or whether a targeted deterrent should be aimed at those promoting the arrangements. The latter was viewed as preferable at the time, so in 2006 a penalty regime to deter the promotion of tax exploitation schemes was presumed to be the more effective approach, especially with the ability to seek voluntary undertakings from the promoter or court injunctions.⁶⁴ In response to the need to provide more guidance, the ATO employed targeted advice material, *Don't Take the Bait*, and fact sheets for Investors Tax Planning – *Investigate before investing* – to give simple, clear tips to investors.

IX ATO PRESENCE ON THE INTERNATIONAL FRONT

Today we marvel that wealth can be made rapidly by young entrepreneurs devising digital services to a mass audience. The scale of such value creation with global activities defies the traditional concepts of 'source' and 'residence' and creates new issues to solve. The new words to describe the attendant loss of country revenue by groups using global tax-advantaged positions cannot be labelled with the old nomenclature, so a new term is coined, 'base erosion and profit shifting'. With much global attention, the Organisation for Economic Co-operation and Development (OECD) has progressed its work on base erosion topics, and has pursued the development of guiding principles aimed at achieving greater tax

⁶² Commissioner of Taxation Annual Report of 2000–01 at 49.

⁶³ For example, the Budplan scheme case of *Howland-Rose & Ors v FCT* 2002 ATC 4200 where tax benefits were denied by the court, and denial of research and development expenses in the Administrative Appeals Tribunal case of *Brody & Ors v FCT* 2007 ATC 2493.

⁶⁴ *Taxation Laws Amendments (2006 Measures No.1) Act 2006*. The government has signalled its intent to progress a new disclosure reporting regime for aggressive tax planning schemes to apply to tax and financial advisors. A May 2016 Treasury consultation Paper, *OECD Proposals for Mandatory Disclosure of Tax Information*, closed for comment in July 2016.

transparency and consensus measures that can be adopted by countries in their domestic laws. It is anticipated that the implementation of improved avenues to exchange information between jurisdictions, and proposed multilateral instruments to efficiently implement treaty changes without the need to renegotiate a myriad of bilateral treaties, will augment international cooperation between countries to combat treaty shopping and other forms of treaty opportunism.⁶⁵ There is inherent good sense in finding shared solutions for commonly encountered problems, in the world of tax.

Looking back to overseas postings in the 1970s, the ATO had representatives in two locations, London and in Washington DC.⁶⁶ This was at a stage when just nine double tax agreements had been negotiated. I was posted to Washington DC in 2005–07 to a designated task force to assist with our overseas work. I was co-located with other countries, and there was more focus on tax risk. During my posting, a small US-based international task force shared expertise to review international ‘tax shelter’ cross-border arrangements⁶⁷ through the lenses of primary drivers of bank secrecy jurisdiction concerns, tax law mismatches, financing arbitrage, use of structures, concessions offered, losses and the adequacy of the tax administration approaches to detect and deter the promotion of schemes. This was all executed in an environment which was strictly subject to our respective treaty exchange limitations. It was an initiative of its time, and served its purpose well for participating countries to build stronger collaboration and understanding of the shared global tax challenges.

At present the posting is for one representative located at the OECD in Paris providing a full-time representational role and contributing to international programs of work. More commonly, in the current age of communication, we are better placed to hold international conference calls with our overseas revenue agency colleagues. Conference calls are conducted between separate teams representing each country, with appointees performing the role of Competent Authority to ensure the treaty rules are observed and to organise information flows.

The development of joint participation with other international revenue agencies was established through the quaintly named SGATAR, PATA, and CATAR groups.⁶⁸ In thinking back on our contribution to these forums, my experience was that they consisted of rewarding, albeit rudimentary work with developing countries at one level, and to more sophisticated exchanges of tax risk analysis practices with the more advanced economies. Have things changed that much? Well, to me, finding consensus on cross-border tax work requires diplomacy – not unlike the well-quoted description of what was required for success in foreign diplomacy:

There is nothing dramatic in the success of a diplomatist ... such victories ... are made up of a series of microscopic advantages: of a judicious suggestion here, of an opportune civility there, of a wise concession at one moment and a far sighted persistence at another... [that] no blunder can shake.⁶⁹

⁶⁵ BEPS Action Item 15 re a proposed OECD multilateral instrument to basically assist with treaty amendments for the BEPS action items.

⁶⁶ Then called ‘Counsellor (Taxation)’ in Washington DC and an ‘ATO Representative’ in London.

⁶⁷ Refer explanation in Australian Government *ATO Compliance Program 2010–11* at 27.

⁶⁸ Study Group on Asian Tax Administrations (SGATAR), Pacific Association of Tax Administrators (PATA) (no longer exists) and Commonwealth Association of Tax Administrators (CATAR).

⁶⁹ Lord Salisbury, Foreign Minister in UK Government, 19th century quote.

Collaboration by member countries to produce guidance on OECD project groups, in the pre-Base Erosion and Profit Shifting (BEPS) environment, epitomised this world of diplomacy. My experience was in an OECD study, as co-lead with a civil servant from Her Majesty's Revenue & Customs (UK), which had started to review ways to achieve better tax transparency for banks in early 2008. Banks that were consulted initially negotiated judiciously on the terms of reference for the study, to keep it focused on investment banking. However, the global financial crisis descended not long after the study got underway, which in one sense gave it greater impetus; yet it soon attracted a cautionary concern at another level as some banks began teetering towards collapse. The intended practical guidance for tax examinations by revenue administrators was overtaken by bailouts and other global events, such as new financial regulations taking precedence.⁷⁰

In the modern world, tax advocacy group campaigns and media headlines reveal intelligence leaked in documents from 'whistle-blower' informants that enabled publication of hidden sources of income and previously well shielded global tax avoidance or evasion practices. This greatly assisted the G20 Leaders to formulate Communiqués to acknowledge the risks of base erosion to modern tax systems and the consequent risk to their economies. It gave tax priority, thus allowing the pace of work and outputs to progress at a much faster pace than we have ever experienced in our history.

X AREAS OF RECENT INTEREST

A *Profit Shifting*

On the same operative date as the new general anti-avoidance rule (GAAR) came into effect (Part IVA, 27 May 1981), the then Treasurer also foreshadowed law to counter the practice known as transfer pricing, where parties to an international transaction do not deal with each other at arm's length and locate profits outside Australia (for example with high expenses in Australia) and thereby avoid Australian income tax – sounds like profit shifting.

Transfer pricing of goods, services and intangible property is an area of law involving complex legal and economic concepts and in which we have been reliant on experts to guide us through methodologies on arm's length pricing. The courts and tribunals have not always embraced the economic conclusions that either the ATO or the taxpayer relies upon, as advised by its experts.⁷¹

More than 30 years later we have brought in more workable laws to deal with modern-day transfer pricing of goods and services, but the whole changing world of digital commerce will ensure that it is a topic of attention well into the future of the global world of tax

⁷⁰ The report was commissioned by the Forum for Tax Administration (FTA) at the January 2008 Cape Town meeting. The booklet was published by the Organisation for Economic Co-Operation and Development booklet: *Building Transparent Tax Compliance by Banks*, 2009. The study team comprised the Australian Taxation Office, HM Revenue & Customs in the UK and the OECD Secretariat. Assistance came from 12 other FTA countries and two experienced banking personnel seconded to the study team.

⁷¹ Refer to Justice Downes of the AAT in *Roche Products Pty Ltd v FCT* [2008] AATA 639 who declined to accept the experts view of certain 'appropriate mark-ups' and 'medians' in inter-quartile ranges and in the absence of (in his view) a rational basis for distinguishing profit margins between comparable and non-comparable drugs, he determined a separate gross profit margin for prescription pharmaceuticals based on other evidence.

administration. The ability of companies to choose preferred jurisdictions in which to locate their value chain, source a function or adopt a risk has enabled some enterprises to shift profits and access significant worldwide reductions in the effective incidence of tax. Future tax administrations, however, although assisted by administrative safe harbours and interpretative guidance, will continue to track the complexities of international transactions to assess tax compliance risks, if disclosures are not comprehensive and reliable.

Any time the ambit of the GAAR provisions are extended we see a flurry of interest, as it traditionally brings in a fresh era of tax interpretation and comment from tax professionals. This may be a feature of challenges by the ATO to perceived abusive global multinationals' tax positions, and I expect the new multinational anti-avoidance law (MAAL), applying to tax benefits of significant global entities (effective from 1 January 2016), will be no different in setting new parameters of tax law controversy.⁷² The MAAL measure targets multinational entities that use artificial and contrived arrangements to avoid attribution of profits and so do not return a sufficient proportion of profit from Australian sales. Dialogue with the ATO is encouraged by affected entities, and it is expected that they will restructure their business chains to conform with and apply for ATO rulings to be assured their operations do not breach these new laws.⁷³

The community has seen a greater level of transparency in who pays their fair share of tax, and through advocacy groups and the media will be more vocal in holding companies accountable if not.⁷⁴ The ATO, like other administrations, seeks to stay current by reviewing the tax impact of taxpayers' commercial and financial dealings so we can spot the trends, provide certainty in our views, and assure the community we are fulfilling our role in signalling acceptable levels of tax to profits.⁷⁵ Notwithstanding these efforts to effect unilateral law changes and agreement to minimum standards of multilateral rules, the future changing technological environment will surely present its own challenges to the ability of tax administrations to address global (non-symmetrical) tax structuring and transparency, and will continue to require some degree of international coordination and cooperation to keep pace with innovative arrangements.

B High-Wealth Individuals

Another memorable watershed for the ATO was the establishment of the High Wealth Individuals Taskforce. In Australia in the 1995–96 tax year, the ATO trail blazed the segment by uncovering a small number of apparently wealthy family groups paying little or no

⁷² The new provisions amend the general anti avoidance rules and apply to significant global entities in regard to schemes entered into on or after 1 January 2016. The Explanatory Memorandum to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* explains (at 54) that the amount of penalty is doubled when imposed on qualifying entities that enter into profit shifting schemes, unless the entity has adopted a tax position that is reasonably arguable.

⁷³ Refer to ATO, Law Companion Guideline LCG 2015/2: Section 177DA of the *Income Tax Assessment Act 1936*: Schemes that limit a taxable presence in Australia.

⁷⁴ On 3 December 2015, the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 passed the Australian Senate requiring annual financial statements disclosing levels of tax by entities.

⁷⁵ The recently published 1st annual Corporate Transparency Report involves a transparency population of 1,539 entities (1,042 corporates with annual turnover >\$250m) for the 2013–14 income year, issued by the ATO on 17 December 2015, is one way to inform public debate about tax policy into the corporate tax system. A further release of taxation data for Australian-owned, private resident companies occurred in March 2016 to further assist the global push for transparency in the corporate tax system.

personal tax through a web of associated trust and company structures, thereby allowing one or more individual members to access welfare. Because privately owned and wealthy groups operated some of Australia's largest and most successful businesses, we conducted an extensive compliance review to work out their effective tax rates. We were faced with often complex financial and legal arrangements which many had structured to obscure, for revenue authorities, detection of any tax avoidance or tax sheltering. Some countries have more recently levied a greater burden of tax (or called for a tax surcharge) on their high-net-worth individuals or top-end earners, noting the disproportionate distribution of income as the gulf widens between the top 1 per cent and the rest. Aberrations like wealthy US hedge fund managers paying lower rates of capital taxes than ordinary people on their carried interest returns (ie not being treated as ordinary income) is one tax break for the elite.

Tax evasion, avoidance and crime (abuse of offshore secrecy arrangements) was addressed through the establishment of the Project Wickenby Taskforce in 2006. This involved a partnership of eight agencies to address the use of secrecy jurisdictions by individuals to avoid tax. Work is presently done through the eight multi-agency Australian Serious Crime Taskforce for serious and complex financial crimes.⁷⁶

Successful work by the Wickenby taskforce included approaches akin to tax amnesty to encourage people to come forward and voluntarily disclose unreported taxable income and obtain reduced penalties. For example, the 2014 voluntary disclosure initiative known as *Project DO IT*, which provides Australians with opportunities to declare undisclosed or incorrectly reported offshore financial activities, has seen 5,800 disclosures (as at 30 June 2015) lodged with the ATO. This is an example of newer approaches being adopted, and of the ATO working with the wider community to encourage international transparency in its dealings with the tax system.

In addition, *Project DO IT* assists with intelligence information on the range and scope of inappropriate offshore arrangements, including those who chose not to voluntarily disclose income, and it can be used to inform the ATO about risk and compliance approaches.

XI EXTERNAL SCRUTINY OF THE ATO AND THE ROLE OF THOSE CONDUCTING ATO OVERSIGHT

While the ATO has had its own (internal) audit committee since 1998–99, external scrutiny has taken place through various avenues.

A *The Australian National Audit Office (ANAO)*

The ANAO, as a separate government agency, has regularly conducted efficiency audits of the ATO for many years, about particular functions or advice, audit and debt programs of the ATO as well as aspects of tax administration.

⁷⁶ See ATO Compliance Program 2011–12 at 24–5. The 7 other ATO partners for the current SFCT are: Australian Criminal Intelligence Committee, Australian Federal Police, Australian Securities & Investments Commission and (Cth) Director of Public Prosecutions, Australian Transaction Report and Analysis Centre, Australian Border Force and the Attorney General's Department.

B The Inspector-General of Taxation (IGT)

The IGT, as an independent reviewer, now incorporates tax complaint handling.⁷⁷ The appointment of an IGT took place along with proposals for a Board of Taxation following the 2001 Federal election, where the option was raised as a way to balance business advice from the ATO and Treasury and to complement the Commonwealth Ombudsman's role with individual taxpayers.⁷⁸ The ATO provides assistance to support the work of the eleven-member advisory Board of Taxation, which initiates tax system improvement measures or assistance with studies on tax matters at the request of the Treasurer. The functions given by Parliament to the IGT broadly consist of conducting reviews, at his own initiative, of the range of ATO systems used to administer tax laws.⁷⁹

In the 2014–15 year Commissioner Jordan reported, in his Annual Report in respect of external scrutiny reviews, that four Australian National Audit Office (ANAO) audits, five IGT reviews and one Commonwealth Ombudsman own-motion investigation were completed. In the current year (2015–16), three ANAO audits and two IGT reviews were completed, along with the (former) House of Representatives Standing Committee on Tax and Revenue Inquiry in early 2016.

C Parliamentary Committees

The Senate Economics Reference Committee (SERC) and House of Representatives committees can conduct inquiries into the operations of the ATO, and often the issues stem from media or community concerns. An example was the Senate referral of an enquiry into corporate tax avoidance of multinationals to the SERC, where some companies were called to provide evidence before the committee, as was the Commissioner and his officers. The changing dynamics of late reflect the greater degree of openness with which companies were asked to, and did, provide information about tax performance and tax compliance – information that is usually not in the public domain. It gave a greater insight into the real challenges of the ATO in reviewing and examining the complex financial affairs of large global corporations and certain stresses on the tax framework that requires close administering.

In present times, the House of Representatives Standing Committee on Tax and Revenue has a mandate to examine annual reports of agencies allocated to it by the Speaker of the House or a Minister.⁸⁰ After conducting hearings at which tax officials and key witnesses gave

⁷⁷ The ATO website notes that from 1 May 2015, the tax complaint handling role was transferred from the Commonwealth Ombudsman to the IGT as a way to enhance the systemic review role of the IGT and provide taxpayers with specialised and focused complaint handling for tax matters. The purpose of this move is to enhance the systematic and unique review role of the IGT.

⁷⁸ Josh Gordon, in his article in *The Age* of 22 March 2003 titled '*Senator slams Labor for impeding tax reforms*', stated that 'Facing a serious tax administration backlash during the 2001 federal election campaign, the Government promised to install an inspector-general of tax with inquisitorial powers to access confidential Tax Office information...Senator Coonan said the Government had an election mandate to introduce the reforms, and would not back down.'

⁷⁹ Sections 7 and 8 of the *Inspector-General of Taxation Act 2003*. The IGT may be requested to carry out a review by the Commissioner of Taxation, a Minister, a resolution of a committee of the House, but is not required to comply with the request.

⁸⁰ Standing Order 215. The Committee commenced to act as a scrutineer of the ATO in February 2014, a responsibility previously held by the Joint Committee of Public Accounts and Audit (JCPAA), to look into its previous year Annual Report to Parliament and assess ATO progress.

evidence,⁸¹ a report of the committee published its views, noting the moves towards simplification of tax returns, contemporary service and a commitment to comprehensively assess the tax gap.⁸² In the following review of the Commissioner's 2015 Annual Report it was reported that:

[3.33] The ATO is in the midst of two great, and related, changes. The expansion of the digital economy has meant that it is involved in an extensive program of technological change which in some cases is profoundly altering its approaches to doing business. At the same time it has embarked on a program of cultural change which is wide ranging enough to deserve the title 'Reinventing the ATO'.⁸³

Parliamentary committees will continue to review successive ATO annual reports, and it might be expected that interesting topics and oversight reports will engage the hearts and minds of the community where public interest matters arise.

The extent of external scrutiny and inquiries into the management and effectiveness of government agencies including the ATO, whatever the subject matter, is likely to continue.

XII TAX APPEALS AND DISPUTE RESOLUTION

The (then) Special Tax Adviser in the office of the Ombudsman (Cth) was one of our first external case mediators for disputes,⁸⁴ but since that time the ATO has moved to more available and trained in-house facilitation services to resolve disputes with taxpayers, and other formal and informal services as avenues for Alternate Dispute Resolution.

From our early times at the Taxation Boards of Review (now the Administrative Appeals Tribunal)⁸⁵ I, as one of the young Appeals and Review officers dealing with a considerable back log of (mainly individual taxpayers) smaller tax cases,⁸⁶ regularly appeared for the Commissioner before the members of the Boards. The attractiveness of a low \$2 appeal fee meant many people got their day at the Board and were self-represented or accompanied by their tax agents, and we were presented with some truly novel arguments, for example as to the need for lavish entertainment expenses, or for a barrister to be allowed his personal home water rates because he read his legal briefs in the toilet and while relaxing in the pool. Then there was the man who argued he should be allowed to depreciate his brain (for tax

⁸¹ Witnesses at the second hearing included the Commissioner of Taxation and senior staff of the Australian Taxation Office; Inspector-General and Deputy Inspector-General of Taxation; Senior Tax Counsel of the Tax Institute; Senior Tax Adviser of the Institute of Public Accountants; Head of Tax Policy of the Institute of Chartered Accountants of Australia and the CEO of the Council of Small Business Organisations of Australia.

⁸² *Review of 2013 Annual Report of the Australian Taxation Office*, Second Report, House of Representatives Standing Committee on Tax and Revenue, October 2014, at para 1.4.

⁸³ *Review of the 2015 Annual Report of the Australian Taxation Office* – First Report, tabled on 5 May 2016, Chapter 3. For the 44th Parliament the Committee comprised ten Members of the House of Representatives, with six members nominated by the Government and four nominated by non-Government parties.

⁸⁴ A recommendation of the JCPAA in the 1990s.

⁸⁵ On 1 July 1986 the Administrative Appeals Tribunal took over the tax jurisdiction of the Taxation Boards of Review.

⁸⁶ Around 80,000 cases nationally of which 47,000 were cleared in the 1991–92 tax year. See Annual Report at 35.

deduction purposes); the Commissioner argued in response that he should not be afforded a deduction for depreciation as his brain would have been fully depreciated already.

This leads me to litigation and memorable case law, which is too numerous to give justice to in this article. It will invoke some dissent, but I'll say that some impacted us organisationally more than others. The ones I think had the widest impact related to individuals' claims for work-related expenses which we had considered private in nature, such as stockings for flight attendants and sunglasses for outdoor workers, or a student receiving youth allowance yet being allowed to deduct education expenses against that income.⁸⁷ The Test Case Litigation Program gave rise to a useful avenue to fund clarification of these types of contentious areas of the tax law.⁸⁸

Overall, the ATO has a solid history of litigation, and it reflects good decision making by our tax administration. In the tax avoidance realm we were relieved to have the 'no nonsense' *Spotless* decision handed down, which has stood the test of time as referenced in the recent Federal Court *Orica* decision.⁸⁹ Other cases, where we did not succeed in applying the anti-avoidance rules – such as *Mills v FCT*⁹⁰ – mark legal clarification points in our strategic litigation program. It is likely, as strategic litigation evolves in 'hot spot' areas of global profit shifting, that the general anti-avoidance provisions will continue to be a relevant source of jurisprudence for Australian taxation purposes.

Actually, it was the more mundane topic of debt and deductibility of interest that gave rise to some of the more interesting tax cases, from the early days of questioning whether something was in the nature of interest and properly deductible or of a capital nature. Currently the most recent decision in *Chevron*, a transfer pricing case on the arms' length price of interest on a loan between related parties,⁹¹ is the first jurisprudence on that topic, and its outcome will not only steer the (previous) Division 13 of the ITAA 1936 but may well influence the testing of the replacement provisions of Subdivision 815-B and/or 815-C of ITAA 1997. The OECD's BEPS study was quite explicit in targeting consultation on three other tax risk areas where excessive interest deductions need to be countered: debt dumping or debt loading in high-tax countries; creation of intra-group debt at rates in excess of third party debt; and the mismatch of tax exempt income being able to be funded by deductible intra-group debt. Only legislative change can address these issues effectively in participating countries.⁹² Law clarification litigation necessarily means cases are lost and won by the ATO

⁸⁷ High Court decision in *FCT v Anstis* [2010] HCA 40 re youth allowance.

⁸⁸ The ATO Test Case Program received Ministerial approval for the 1995–96 tax year, and \$2m of funding was secured from the Department of Finance. In 2006–07 the IGT reviewed the administration of test case litigation and although found it to be soundly conducted recommended a number of changes to improve its operation: *Review of Tax Office Management of Part IVAC Litigation*, Chapter 6, 28 April 2006.

⁸⁹ See Commissioner of Taxation, *Annual Report 1999–2000*, 80. Refer to *FCT v Spotless Services Ltd* (1996) 186 CLR 404 and *Orica Limited v FCT* [2015] FCA 1399.

⁹⁰ *Mills v FCT* [2012] HCA 51.

⁹¹ *Chevron Australia Holdings Pty Ltd v FCT (No 4)* [2015] FCA 1092. Appeal to the Full Federal Court was undecided at the time of writing.

⁹² BEPS Action Item 4 OECD publication 2015. The UK's HM Treasury, as part of its Budget 2015 announced 'new business tax roadmap', released an open consultation paper on 22 October 2015 to seek views on how best to respond to the OECD proposals for countries to counter these risks and to modernise interest deductibility rules. Australia's Thin Capitalisation rules introduced in 2001 were strengthened in 2014 to prevent erosion of the Australian tax base from debt loading by introducing a safe harbour for general entities (with debt deductions >\$2m) of 1.5:1 and a worldwide gearing amount and a safe harbour limit for banks along with a capital limit.

over time, and the outcome is often dependent on the weight of evidence regarding the alleged mischief in Australian tax law terms, as the Revenue seeks to interpret some novel and interesting aspects of the tax system that give unintended relief and do not follow the more equitable policy principles proposed.

It is difficult to predict what future courts may have to ponder although ... our pivot towards a greater readiness to engage in Alternate Dispute Resolution means that we can deal more flexibly with inevitable disputation and ensure that the path to resolution of tax disputes will continue to be refined to practically give fair and equitable outcomes.⁹³

The remaining area to embark upon for our country is the novel notion of arbitration for unresolved double tax cases, where a taxpayer has requested Competent Authority intervention to assist in reducing or eliminating the economic or actual (two+ country) tax on the same profits. A Mutual Agreement Procedure (MAP) that is not resolved within a two-year period (ie country limitations will apply) can follow the OECD BEPS 14 proposal.⁹⁴ This proposal involves a mandatory binding MAP arbitration provision, which is to be negotiated as part of a 'multilateral instrument' that countries would ratify (as envisaged under BEPS Action Item 15). So, while some years away it presents a path forward for aspects of treaty disputes where it is otherwise hard to make progress or get any real traction.

XIII FUTURE EVOLUTION OF TAX

At one level, the tax administration of the future is about a number of initiatives working in harmony.

One valuable key initiative that will change many issues about tracking individuals' PAYG payments in the future is the 'Single Touch Payroll'. Once fully developed, it is capable of assuring employees that tax and superannuation are being deducted and remitted to the ATO on their behalf. In this new environment, payroll data can be sent to the ATO in real time. Then progressive payslip information is remitted to the ATO, rather than leaving the annual payment summary at the end of the tax year as the point of reconciliation (for tax and super).

The technology initiatives of the future will also incorporate elements of what have been piloted today, such as 'voice biometrics'. This style of speech analytics leverages the fact that every voice has unique physical and behavioural attributes, which include both (stable) tonal as well as (transient) environmental characteristics. A caller can voluntarily agree to allow their voice characteristics to be recorded to allow identification and retrieval of account details to assist with service queries.⁹⁵ Apart from voiceprints to allow for speedier

⁹³ House of Representatives Standing Committee on Tax and Revenue Report of March 2015 acknowledges that given different attitudes to tax and its complexity, disputes are 'inevitable', at 1 and recommendations made.

⁹⁴ *Making Dispute Resolution Mechanisms More Effective*, OECD BEPS Action Item 14 – 2015 Final Report, October 2015. On 31 October 2016 the OECD released a Schedule for country peer reviews together with the Terms of Reference to translate Action Item 14 minimum standard into 21 elements that are used to assess the legal and administrative framework of MAP programs in all countries being reviewed. A MAP reporting framework with statistics and profiles are to be published to assist with MAP guidance.

⁹⁵ As at January 2016, 1.4m people had voluntarily agreed to enrol to use this technology for their identification in relation to discussing their own tax affairs, and this number is expected to increase.

identification, there is the use of virtual assistants to resolve online enquiries and the launch of the ATO app. Such initiatives, along with the myGov fast, simple access to online services, will better shape the efficiency and effectiveness of our interactions with clients from the taxpayer population.

If we extend that thinking into the future, it is likely to mean our tax administration could potentially:

1. Embed a stream of contemporary digital services into our operations, that allows individuals to be alerted to, and helped with their obligations in advance;
2. Employ a complete range of global data sets that feed into analytic programs for holistic assessment of any direct or indirect tax risk and shift resources to emerging hot spots;
3. Achieve improvements in fairness and equity through:
 - a) leveraging behavioural psychology approaches beyond just debt collection initiatives and into innovation, to balance systems changes;
 - b) pursuing reliable assurances from business (eg 'justified trust')⁹⁶ to manage and control levels of large business compliance and international transparency; and
4. Demonstrate to government and the community that the tax and superannuation system continues to be well managed.

In the future, any new principles and programs should have enough flexibility to meet whatever economic, political, social or business need arises. Tax administrators who have worked in the service for many years have usually experienced the joys of seeing initiatives work and also experienced the disappointment of seeing courageous ideas flounder,⁹⁷ notwithstanding some truly valiant briefings to those that decide our policy and administrative settings.

Overall direction setting suggests that future growth is dependent on a strong, sustainable and balanced economy supported by a robust tax system. What the ATO desires as a capable and trusted tax administrator requires setting some strategic goals or aspirations, which in my view would include the following:

1. An efficient approach to personal income tax reporting with minimal compliance costs.⁹⁸
2. Tax being a function of business profits, not a separate global cost centre, so that tax follows the profits where they are made, rather than being an 'orchestrated product'.

⁹⁶ See for example an OECD Report in 2013 *Cooperative Compliance: A Framework*, which describes how tax administrations and large corporates base their relationship on mutual transparency, understanding and justified trust.

⁹⁷ Leigh Edmonds in the *Working for all Australians 1910–2010: A Brief History of the Australian Taxation Office*, ATO Canberra publication November 2010, 167 provides a *Eulogy for a tax bill* story, where an ATO senior official recounts receiving a bereavement card from a first Parliamentary Counsel, after the death of 5 tax bills that did not make it into law. The bills were designed to assist states to collect 'receipts taxes' and they were never legislated.

⁹⁸ Digital advances will allow improvements in prefilling of individual income tax returns with employment details, financial data (eg interest) and share data (eg dividends) and access CLARIFY account details.

3. Tax administrators understanding tax performance and perceived weaknesses in the tax and superannuation systems, through:
 - Creation of astute mechanisms for certainty to resolve disputes and advise on ATO interpretation of the various tax laws applicable to situations in an environment where the full facts are known and understood.
 - An advanced analytics program which is capable of organising our ever-increasing warehouse of data⁹⁹ in such a way that the ATO can find and use those key bits of information that will help us target our activities and programs in a more effective way to support operations including lodgment, debt, disputes, advice and assurance work.
 - The thirst for behavioural insights into patterns of compliance, risk and measurements of tax gaps should continue well into the future.
4. Having an inclusive, well-functioning program for streamlined and collaborative interactions with clients across Australian government agencies and international revenue agencies.
5. Enhanced 'real time' exchange of data and global business trends. In an age where service provider companies can bounce personal information around their global data centres (subject to privacy or regulatory constraints), tax administrations should use financial transparency initiatives to employ increasingly sophisticated automatic exchanges of information. A framework with other countries is proposed to be in place by 2017–18, along with the 'minimum standards' to be implemented which:
 - Create an improvement on the existing network of bilateral treaties through the widespread implementation of the BEPS action plan areas such as prevention of treaty shopping, country-by-country reporting, anti-hybrid rules, fighting harmful tax practices, etc.¹⁰⁰
 - Modernise all relevant partner country tax rules. The degree to which each country is able to adopt the suggested BEPS measures usually depends on what carve-outs businesses in that economy are willing to allow and the extent of administrative capability.
 - Check global trends and monitoring for double non-taxation.
6. Capacity to build for new challenges, prevent threats to the tax and superannuation systems and work towards fixing stresses on the administration through:

⁹⁹ The ATO holds and receives enormous amounts of data each year and it is growing at a rate of over 20%pa. In addition the ATO receives over 600m transactions of data each year from third parties. Such information flows will be further enhanced, through for example, Country-by-Country reporting, the Foreign Account Tax Compliance Act (FATCA) intergovernmental agreement, Common Reporting Standard, Foreign Investment Review Board (FIRB), mandatory disclosure and automated exchange of rulings.

¹⁰⁰ The instrument was announced by the OECD as open for signature by all interested countries who want to assist with its implementation from 2016 (refer BEPS Final package of reports: Explanatory Statement 2015). This is BEPS Action Item 15 and incorporates Action Items 2, 6, 7 and 14. The existing global pool of around 3,600 bilateral double tax treaties have restrictions on how modern tax administrations can work together to improve their understanding of the dynamic of tax planning through transparency. The lesson was that we gain better momentum and ownership when moving in a responsive and coordinated way to new challenges to the integrity of our tax systems.

- Maintaining a capable qualified workforce that understands the long-term impact that compliance strategies, policy implementation and concessionary rulings have on community confidence and the future of tax effectiveness.
 - Modernising international tax rules to support multilateral approaches around cross-border harmful tax practices and transparency.
 - Working collaboratively with sectors of the community to improve the efficiency and experience of the tax and superannuation systems.
7. Advanced risk systems capability of the individual and the small business sectors and a deeper understanding of large business to provide:
- More accurate and comprehensive tax gap measure;¹⁰¹ and
 - Swifter dispute resolution mechanisms.
8. Continuing interest and scrutiny in public Senate/parliamentary domain as to whether multinationals and global citizens are paying their fair share of tax. At the international level, the focus on transparency and combating tax evasion is a consensus path. Checking implementation of minimum standards by conducting global reviews of country programs are the current monitoring approach of OECD peer review groups. If this approach achieves a better standardization of documentation procedures and if it provides improved tax certainty to guarantee future revenue flows, then it is likely to be an ongoing assessment framework.

XIV CONCLUSION

A blueprint for a modern tax administration to be efficient and effective suggests some desirable features including adequate operational autonomy and adequate resources, together with a stable legal framework for assessment, collection and enforcement, while at the same time the administration remains accountable for its actions and is subject to control and assessment.¹⁰² Assuming these features are present, the resulting outcome should be a very good standard of tax administration, service to the community and advice to government. The ATO, drawing on its long history, expects to continue to meet community expectations with whatever the future of administration of the tax and superannuation system holds.

¹⁰¹ Recommendation 5 of the JCPAA Report 398 was for the ATO to provide a mechanism to calculate the tax gap to increase overall efficiency and prevent GST fraud. In the Annual Report for 2014–15 the ATO added a number of new tax gap estimates to our GST and luxury car tax tax gaps, and plans to advise other tax gaps this tax year.

¹⁰² See Footnote 9. European Commission *'Fiscal Blueprints – a path to a robust, modern and efficient tax administration'* European Communities 2007 for best practice international application.

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IS THE CITIZEN-CONSUMER THE FUTURE TAXPAYER?

JONATHAN BARRETT*

ABSTRACT

The conception of citizenship popularised by Thomas Marshall includes a social element, in terms of which citizens are taxpayer-beneficiaries of the Welfare State. In the context of the neoliberal dismantling of the Welfare State, social citizenship has been greatly reduced in status. Today, citizens may be conceived simply as consumers of the goods and services supplied directly or indirectly by the State. Merging and developing traditional ideas of citizenship and consumerism, the European Union has promoted the image of the citizen-consumer. Citizen-consumers are expected to actively protect their own interests but also to be alert to the sustainability of the community and the environment, and to be altruistic. This exploratory article considers how this emerging model of citizenship might apply to taxpayers.

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I INTRODUCTION

The social element of Thomas Marshall's trifurcated conception of citizenship was reflected in the different tax-welfare systems established in Western countries during the twentieth century.¹ Francis Castles differentiates between Australasian, British, and Nordic welfare models;² nevertheless each scheme was informed by the idea that workers would willingly pay income taxes (and social insurance contributions) in exchange for the promise of some form of State protection. Although the Marshallian model remains the archetypal starting point for discussions of citizenship,³ in the context of the neoliberal dismantling of the Welfare State, this conception of social membership has become moot. Indeed, taxpayers may be conceived as no more than consumers of the goods and services supplied directly or indirectly by the State. Government holds no conception of shared social solidarity;⁴ it merely responds to consumer demand signals. Rather than being the beneficiaries of welfare, citizens are 'self-responsibilised' to fend for themselves in the market.⁵ Full social citizenship may, from a contemporary Anglophone perspective, seem as historically remote as the prospect of soviet socialism's eliminating capitalism,⁶ but citizenship does not need to be reduced to individualistic consumption. Past manifestations of citizenship are gone and cannot be resurrected in their old forms, but new ways of civic belonging and participation, including taxpaying, can be imagined.

Merging and developing traditional ideas of citizenship and consumerism, the European Union has promoted the image of the citizen-consumer. According to Jim Davies, citizen-consumers actively protect their own interests but are also alert to the sustainability of the community and the environment, and they are altruistic.⁷ Could this image, which does not seek to resurrect a probably passé model of social

¹ See, generally, TH Marshall, *The Right to Welfare and Other Essays* (Heinemann Educational Books, 1981).

² See Francis G Castles, *The Working Class and Welfare: Reflections on the Political Development of the Welfare State in Australia and New Zealand 1890–1990* (Allen and Unwin, 1985) 77. Broadly, the Australasian 'labour defence' welfare scheme ensures the economic strength of workers so that they can fend for themselves in the market, whereas Nordic 'structural' welfare shelters citizens from the vicissitudes of the market.

³ See, for example, Engin F Isin and Bryan S Turner, 'Investigating Citizenship: An Agenda for Citizenship Studies' (2007) 1(1) *Citizenship Studies* 5.

⁴ See David Harvey, *A Brief History of Neoliberalism* (Oxford University Press, 2005) 80.

⁵ See, generally, Rik Peeters, 'Responsibilisation on Government's Terms: New Welfare and the Governance of Responsibility and Solidarity' (2013) 12(4) *Social Policy and Society* 583.

⁶ Recognising that soviet socialism lost the Cold War does not imply support for Francis Fukuyama's 'end of history' thesis: see Francis Fukuyama, *The End of History and the Last Man* (Free Press, 1992). Authoritarian capitalism appears to be prospering, inter alia, in China and Vietnam. It would, therefore, be a brave undertaking to predict which illiberal ideologies might continue to thrive or take root as the twenty-first century progresses.

⁷ See, generally, Jim Davies, *The European Consumer Citizen in Law and Policy* (Palgrave Macmillan, 2011). Davies tends to refer to 'consumer-citizens'. I reverse the word order to privilege citizenship over consumerism.

citizenship but does aim to counter the sterility of citizenship as consumerism, be applied to taxpayers?

This article, which is exploratory in nature, considers the concept of the citizen-consumer in relation to taxpaying. The jurisdictional focus lies with New Zealand, but overseas experience, particularly that of the United Kingdom, is drawn upon. The paper is structured as follows: First, comparisons are made between Marshallian social citizenship; the neoliberal image of the citizen as consumer; and the citizen-consumer envisaged by European Union policy makers. The aim here is to present a concept of citizenship distinct from both social democratic and neoliberal models. Second, the article draws parallels between different conceptions of the consumer and analogous representations of the taxpayer.⁸ Third, the possibility of the taxpayer as a citizen-consumer is considered. To the extent that this approach takes the idea of collective action seriously and is opposed to anti-tax libertarianism, it may be described as communitarian. But it is a nuanced, arguably diluted, version of pre-neoliberal conceptions of community membership. Fourth, reservations are noted about the socially-undesirable possibilities of activism in the field of taxpaying, especially the role of shaming. Finally, tentative policy recommendations are made and conclusions are drawn.

II TOWARDS CITIZEN-CONSUMERS

This part of the article draws comparisons between Marshall's conception of social citizenship; the neoliberal image of the citizen as consumer; and the consumer-citizen envisaged by European Union policy makers. The aim here is to present a concept of citizenship distinct from both the social citizenship and neoliberal models.

A *Social Citizenship*

Marshall outlined a conception of citizenship which included a civil component (rights necessary for individual liberty), a political component (electoral rights) and a social element (ranging from a right to basic welfare to living 'the life of a civilised being according to the standards prevailing in society').⁹ Engin Isin and Bryan Taylor sum up this conception of citizenship as 'belonging to a society through the entitlements associated with service'.¹⁰ In this scheme, citizens willingly pay taxes in the knowledge that, should certain contingencies occur, such as workplace injury or superannuation, they are guaranteed benefits from the State.¹¹

⁸ While demurring from using such grand terms as Foucaultian 'epistemes' or Kuhnian 'paradigms', it is submitted that government approaches to taxpayers are distinguishable in different periods.

⁹ Marshall, above n 1, 74.

¹⁰ Isin and Turner, above n 3, 5.

¹¹ See Bernard Cadogan, 'Welfare Policy: Governance History and Political Philosophy' Treasury (2013) 86; Karen Boll, *Taxing Assemblages – Laborious and Meticulous Achievements of Tax Compliance* (PhD Thesis, IT University of Copenhagen, 2011) 107.

Marshall was a sociologist, rather than a political philosopher. His conception of citizenship has nevertheless assumed a normative quality.¹² The Marshallian model of social citizenship is, then, commonly used to tell us what citizenship ought to look like. But Marshall's conception of citizenship is specific to a particular time, place and, probably, social class and gender (1945–1985, developed countries, working class men);¹³ it is neither universal nor fixed. This quality of contingency has been starkly demonstrated by the diminution of the status of the worker–taxpayer–beneficiary in the face of neoliberal globalisation.

B Neoliberal Citizenship

Globalisation is, in the definition of Robert Patman and Chris Rudd, 'the intensification of interconnections between societies, institutions, cultures, and individuals on a worldwide basis'.¹⁴ Few would deny the overall benefits of globalised technology, such as the Internet, or the worldwide promotion of human rights. Globalisation debate principally lies with the 'costs and benefits of trade liberalization and foreign investment'¹⁵ and 'capital's freedom to move around the world',¹⁶ which are the principal features of *neoliberal* globalisation. This freedom and velocity of capital movement is planned and deliberate, rather than a natural phenomenon, and has required the introduction of a suite of complementary policies. And so, as William Tabb observes, neoliberal globalisation 'calls for trade and financial liberalization, privatization and deregulation, openness to foreign direct investment, a competitive exchange rate, fiscal discipline, lower taxes and small government'.¹⁷ 'Individual responsibility is stressed, while communitarianism or state-run social or cultural initiatives are discouraged.'¹⁸ The principal beneficiaries of neoliberal globalisation are the owners of multinational enterprises (MNEs).¹⁹

¹² See, for example, Virginia Mantouvalou, 'Workers without Rights as Citizens at the Margins' (2013) *Critical Review of International Social and Political Philosophy* 366, 368.

¹³ Social citizenship in New Zealand has traditionally been informed by patriarchal notions: see, generally, Jane Margaret Scott, 'Discourses of Dependency: Women, Work, and Welfare in New Zealand' (PhD thesis, University of Auckland, 2001).

¹⁴ Robert G Patman and Chris Rudd, 'Introduction – New Zealand Sovereignty in the Era of Globalization' in Robert G Patman and Chris Rudd (eds) *Sovereignty under Siege: Globalization and New Zealand* (Ashgate, 2005) 1, 2.

¹⁵ Brian Roper, 'Globalization and the Shift in Policy-Making from Keynesianism to Neoliberalism: The Decline of National and State Autonomy' in Robert G Patman and Chris Rudd (eds) *Sovereignty under Siege: Globalization and New Zealand* (Ashgate, 2005) 23, 33–4.

¹⁶ Alain Touraine, *Beyond Neoliberalism* (David Macey trans, Polity Press, 2001) 14 [trans of: *Comment sortir du libéralisme?* (first published 1999)].

¹⁷ William K Tabb, *Economic Governance in the Age of Globalization* (Columbia University Press, 2012) 3.

¹⁸ Alison Hearn, 'Brand Me "Activist"' in Roopali Mukerjee and Sarah Banet-Weiser (eds) *Commodity Activism: Cultural Resistance in Neoliberal Times* (New York University Press, 2012) 23, 26.

¹⁹ See, generally, Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism* (Metropolitan Books, 2007).

Neoliberalism is founded on the presumption that human behaviour is dominated by self-interest, and social interactions are value-maximising exchanges.²⁰ Indeed, society is imagined as an agglomeration of markets. Through its privileging of individual choice, neoliberalism may seem to respect and promote autonomy, but it is not, as Barry Hindess observes, 'a natural outgrowth' of liberalism.²¹ Whereas liberal thinkers such as Adam Smith, David Hume and Adam Ferguson conceived *homo economicus* as an autonomous subject, whose activities should be free from government interference, 'neo-liberal *homo economicus*', Colin Gordon argues, 'is manipulable man'.²² Neoliberal policies engender civic docility;²³ they also tend to estrange citizens from government, for example, when welfare functions are outsourced to charities. It is plausible that third-sector organisations or for-profit corporations may deliver certain services more effectively than central government,²⁴ but any such efficiency gains may have a cost for democracy. Indeed, Gino Dal Pont observes that, since the neoliberal ascendancy in the mid-1980s, governments have increasingly relied on charities as they retreat from the role of the 'welfare state as the reliable provider of benefit'.²⁵ Colin Crouch, in turn, argues that the less the State directly provides for the needs of ordinary people, the more apathetic those people will become about democracy.²⁶ Likewise, Richard Murphy observes, 'the more a person perceives a direct relationship between the tax they pay and the government, the more likely it then is that the person will vote in elections'.²⁷

In the neoliberal view, consumerism and citizenship may coincide.²⁸ Relative to the rich version of citizenship identified by Marshall, this conception of citizenship must be considered a sterile vision of social membership. Liberals who deny that society is a community would also reject this monadic image of the citizen. Thus, for John

²⁰ See Jonathan Boston, John Martin, June Pallot and Pat Walsh, *Public Management: The New Zealand Model* (Oxford University Press, 1996) 17.

²¹ Barry Hindess, 'A Society Governed by Contract?' in Glyn Davis, Barbara Sullivan and Anna Yeatman (eds) *The New Contractualism?* (Macmillan Education Australia, 1997) 14, 15.

²² Colin Gordon, 'Governmental Rationality: An Introduction' in Graham Burchell, Colin Gordon and Peter Miller (eds) *The Foucault Effect: Studies in Governmentality* (Harvester Press, 1991) 1, 43.

²³ For example, it is widely thought that students typically no longer think of tertiary education as a 'transformative adult learning experience' which may enable them, in turn, to transform society; rather they see their university studies 'as the pursuit of a qualification that can be exchanged for higher salary and status': see Stephen D Brookfield, *The Power of Critical Theory for Adult Learning and Teaching* (Open University Press, 2005) 25.

²⁴ See, generally, Anup Malani and Eric A Posner, 'The Case for For-Profit Charities' (2007) 93 *Virginia Law Review* 2017.

²⁵ Gino Dal Pont, *Charity Law in Australia and New Zealand* (Oxford University Press, 2000) 3.

²⁶ See Colin Crouch, *Post-Democracy* (Polity Press, 2004) 19.

²⁷ Richard Murphy, *The Joy of Tax: How a Fair Tax System Can Create a Better Society* (Bantam Press, 2015) 65.

²⁸ See Ulrich Haltern, 'Pathos and Patina: The Failure of Constitutionalism in the European Imagination' (2003) 9(1) *European Law Journal* 14, 43. The ACT political party in New Zealand explicitly connects consumption and taxpaying – its full name being the Association of Consumers and Taxpayers. A consumer and taxpayer, the name implies, is one in the same actor; consumption and taxpaying are not the separate functions of private choice and civic obligation.

Rawls, society is not a 'private society', rather it is a system of justice and cooperation.²⁹ For those who support the idea of a progressive, discursive democracy,³⁰ the neoliberal hegemony is a dispiriting development. Yet, as Michel Foucault observes, the 'intransigence of freedom' will always assert itself.³¹ Likewise, Steven Lukes's analysis of 'three dimensions of power' leads to the conclusion that domination of people's deep-seated desires can never be 'more than partially effective'.³² All societies have ethical-religious traditions of altruism and social solidarity which are not extinguished by particular forms of government,³³ and will continue to resist selfish individualism. Similarly, Crouch identifies an 'emerging political imperative to protect the human self from the institutional invasion of the market and the giant corporation, and to insist that the market cannot be the only institution through which we pursue human values.'³⁴

Examples may be adduced of specific policies lying dormant,³⁵ but, in general, we should expect traditional values to be expressed in new forms in opposition to neoliberalism. Thus, Howard Glennerster argues that while collective action through trade unionism has declined, other forms of social solidarity will evolve.³⁶ The Brexit-Trump reaction against neoliberal globalisation is an example of a new form of politics emerging – one which appears to be leading to an unpredictable nationalism, not, say, a return to a progressive, inclusive, collectivism seen, for example, in 'the Great Society' and the civil rights movement in the United States.³⁷ Post-Brexit, a feature of Danish communitarianism, the sentiment of *hygge* (cosiness), has attracted much attention in the United Kingdom.³⁸ The Danish tax-

²⁹ See John Rawls, *Justice as Fairness: A Restatement* (ed Erin Kelly, The Belknap Press of Harvard University Press, 2001) 199.

³⁰ On an ideal discursive democracy, see, generally, Jürgen Habermas, *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy* (William Rehg, trans, Polity Press, 1997) [trans of: *Faktizität und Geltung. Beiträge zur Diskurstheorie und demokratischen Rechtsstaats* (first published 1992)].

³¹ Michel Foucault, 'The Subject and Power' in James D Faubion (ed) *Power* (trans Robert Hurley et al) (The New Press, 2000) 326, 342.

³² Steven Lukes, *Power: A Radical View* (Palgrave Macmillan, 2nd ed, 2005) 150.

³³ See Charles Taylor, 'Foucault on Freedom and Truth' (1984) 12(2) *Political Theory* 152, 180–1.

³⁴ Colin Crouch, 'Putting Neoliberalism in its Place' (2014) 85(2) *Political Quarterly* 114, 121.

³⁵ For example, the Labour government in the United Kingdom reversed its position on a 10 percent starting income tax rate: see Frank Field, 'Abolishing the 10p Tax Rate Shattered the Contract on Which New Labour was Based' *The Spectator* (online), 7 May 2008 <www.spectator.co.uk/2008/05/abolishing-the-10p-tax-rate-shattered-the-contract-on-which-new-labour-was-based/>.

³⁶ See Howard Glennerster, 'The Sustainability of Western Welfare States' in Francis G Castles, Stephan Leibfried, Jane Lewis, Herbert Obinger and Christopher Pierson (eds) *The Oxford Handbook of the Welfare State* (Oxford University Press, 2010) 689, 698.

³⁷ See Cornell West, 'Goodbye, American neoliberalism. A new era is here' *The Guardian* (online), 17 November 2016 <<https://www.theguardian.com/commentisfree/2016/nov/17/american-neoliberalism-cornel-west-2016-election>>.

³⁸ See, for example, Charlotte Higgins, 'The Hygge Conspiracy' *The Guardian* (online), 22 November 2016 <<https://www.theguardian.com/lifeandstyle/2016/nov/22/hygge-conspiracy-denmark-cosiness-trend>>.

welfare model has moved towards Anglo-style workfare or 'activation',³⁹ but Denmark remains a high-tax country.⁴⁰ Such fiscal progressivity no doubt promotes equality and its benefits,⁴¹ but whether such attractions will translate into communitarian policies in neoliberal countries is a matter of speculation.

C Citizen-Consumers

The European Union has actively sought to forge a new version of citizenship 'based on a fusion of neoliberal market citizenship with a communitarian element that attempts to countervail the most harmful effect of neoliberal deregulation' but does not resurrect 'the social rights of the Keynesian welfare state'.⁴² Thus Norbert Reich observes that 'there is a legal framework for a European Charter for citizens as consumers in the areas of economic, ecological and legal protection'.⁴³ Davies sums up the changing position of the consumer in the European Union as the phenomenon of moving 'from cog to cognisance of the consumer citizen',⁴⁴ so that 'amongst the capable consumer behaviours there are traits more normally associated with the citizen'.⁴⁵ For Davies:⁴⁶

consumer-citizenship can be explained in terms of the opportunity and power, of the capacity to influence and change the law and policy through, on the one hand, representative and expert network structures of new governance and, on the other hand, the market through direct action in the form of complaints enforcement of consumer rights, redress, switching and ethical buying.

If consumption was once an apolitical means of satisfying material desires, to a great extent, it no longer is. Neoliberal globalisation may have shifted power from the

³⁹ See Johannes Kananen, 'Nordic paths from welfare to workfare: Danish, Swedish and Finnish labour market reforms in comparison' (2012) 27(5-6) *Local Economy* 558; Philip Tees, 'Danish government announces reform of benefits: It should pay to work' CPH Post Online (2 October 2015) <<http://cphpost.dk/news/danish-government-announces-reform-of-benefits-it-should-pay-to-work.html>>.

⁴⁰ Denmark's tax to GDP ratio of 49.9 per cent is the highest in the European Union: see European Commission, *Tax Policies in the European Union: 2016 Survey* (2016) 11 <https://ec.europa.eu/taxation_customs/sites/taxation/files/tax_policies_survey_2016.pdf>.

⁴¹ On the social benefits of equality, see Richard Wilkinson and Kate Pickett, *The Spirit Level: Why Greater Equality Makes Societies Stronger* (Allen Lane, 2nd ed, 2011). However, it may be noted that neoliberal Australia ranks higher than communitarian Denmark in the United Nations Development Programme ('UNDP') Human Development Index: see UNDP, 'Table 1: Human Development Index and its components' (2016) <<http://hdr.undp.org/en/composite/HDI>>.

⁴² Peo Hansen and Sandy Brian Hager, *The Politics of European Citizenship: Deepening Contradictions in Social Rights and Migration Policy* (Berghahn Books, 2012) 113. See Haltern, above n 28, 24-6 on why the lack of organic support for European citizenship has, in part, driven empowerment of consumers.

⁴³ Norbert Reich, 'A European Concept of Consumer Rights: Some Reflections on Rethinking Community Consumer Law' in Jacob S Ziegel (ed) *New Developments in International Commercial and Consumer Law* (Hart Publications, 1998) 431, 466.

⁴⁴ Davies, above n 7, 22.

⁴⁵ *Ibid*, 23.

⁴⁶ *Ibid*, 90.

State to MNEs, but, as Foucault tells us, the exercise of power invites reaction and recalcitrance on the part of those who are the subjects of power.⁴⁷ According to Sue McGregor, 'when transnational corporations flouted their ability to escape state regulation, they... highlighted their own responsibility for... corporate social responsibility',⁴⁸ 'a phenomenon that has triggered the *politicisation of consumption*.'⁴⁹

Davies identifies 'a developing consumer citizenship practice based on the idea of individuals acting, alone or collectively, in the role of a politicised consumer'.⁵⁰ The breadth of this citizenship-consumer practice is not confined to immediate consumer transactions; it 'extends to post-transactional and extra-transactional behaviours that embrace the pursuit of consumer rights, redress, empowerment and representation'.⁵¹

Does this new form of consumerism represent a resurrection of communitarianism? William Davies rejects that possibility outright, saying '[communitarianism] reminds us of the enduring value of customs and heritage; consumerism revels in ephemera. They represent two mutually exclusive visions of ethical sovereignty'.⁵² For David Harvey, it is the ineffectiveness of sporadic communitarian initiatives in the face of the neoliberal hegemony that is relevant. He says they achieve nothing 'except to challenge ethical individualism through small-scale collective solidarities that often turn out to be more protective of individual private property rights and values than generative of new kinds of social relations'.⁵³ Both authors' arguments are plausible, but the critical consideration is that in the context of neoliberal hegemony, collective action is categorically different from traditional communitarianism.

Orthodox communitarianism 'regards society as a community, and this, as the very word implies, means that society is in some a *unity*, a single thing in which individual members are bound together'.⁵⁴ '[S]ocial bonds are valuable in themselves, over and above their value as means to the attainment of other, merely individual goods, are thereby downgraded'.⁵⁵ The classical sociological distinction between social groups is made between *Gemeinschaft* (community, such as church congregation) and

⁴⁷ Michel Foucault, 'The Subject and Power' in James D Faubion (ed) *Power* (trans Robert Hurley et al) (The New Press, 2000) 326, 342.

⁴⁸ Cited by Davies, above n 7, 63.

⁴⁹ Ibid (italics in original).

⁵⁰ Ibid, 141–2. Types of consumers do, of course, vary from the vulnerable to the empowered. As Davies notes, citizen-consumers are at the empowered end of the spectrum: see Jim Davies, 'Entrenchment of New Governance in Consumer Policy Formulation: A Platform for European Consumer Citizenship Practice?' (2009) 32(3) *Journal of Consumer Policy* 245, 245. A critical concern is what happens to 'incompetent' consumers.

⁵¹ Davies, above n 7, 108.

⁵² William Davies, 'Beyond Communitarianism and Consumerism' (March 2006) *Renewal: A Journal of Social Democracy* <https://www.academia.edu/1316395/Beyond_Communitarianism_and_Consumerism>. See also William Davies, 'The Emerging Neocommunitarianism' (2012) 83(4) *Political Quarterly* 767.

⁵³ David Harvey, *Cosmopolitanism and the Geographies of Freedom* (Columbia University Press, 2009) 197.

⁵⁴ Gordon Graham, *Contemporary Social Philosophy* (Basil Blackwell, 1988) 12.

⁵⁵ Stephen Mulhall and Adam Swift, *Liberals & Communitarians* (Blackwell, 1995) 15.

Gesellschaft (voluntary association, such as a public company).⁵⁶ For today's citizen-consumers, community may not constitute an end in itself; rather cooperation and social solidarity may represent instruments for achieving individual goals. In particular, people commonly choose to be transitory and occasional members of online communities, whereas, in the past, the obligatory nature of membership was thought to be one of the defining characteristics of community. This should not be taken as a pejorative view on contemporary joint action; it is simply different from the past.

III CITIZENS AND TAXPAYERS COMPARED

Political rights are an element of the three forms of Marshallian citizenship. Taxpaying and political rights are closely associated.⁵⁷ 'No taxation without representation' was, of course, a rallying cry for the American Revolution;⁵⁸ and remains a compelling proposition for the connection between contribution to the common treasury and democratic rights.⁵⁹ But the main concern of this article is social citizenship and its decline. And so, while noting the importance of political (and civil) elements of citizenship to taxation, this part focuses on the relationship between welfare and taxation.

A *Taxpaying and Citizen Models*

Broad differences can be identified between citizenship and taxpaying in the eras of social citizenship and neoliberalism. More speculatively, emerging characteristics of taxpaying in the new millennium may be identified.

1 *Social Citizenship*

The strongest sentiment of social solidarity is likely to be experienced during wartime, and this may be reflected in fiscal measures. For example, during the Second World War, the highest marginal rate of income tax in the United States was 94 per cent – a measure which 90 per cent of Americans considered just.⁶⁰ Even beyond the emergency of war, very high rates of income tax became normalised, along with substantial welfare transfers. Between 1974 and 1979 in the United Kingdom, the highest marginal rate of income tax was 83 per cent; in addition, a 15

⁵⁶ See Talcott Parsons, 'Notes on *Gemeinschaft* and *Gesellschaft*' in Max Weber *Theory of Social and Economic Organization* (Trans. AR Henderson and Talcott Parsons, William Hodge, 1947) 686–94.

⁵⁷ It might be more plausible to argue that, historically, voting has been most closely connected with property ownership or military service: see Neill Atkinson, *Adventure in Democracy: A History of the Vote in New Zealand* (University of Otago Press, 2003) 53 and 181.

⁵⁸ In an equally pithy rejoinder, in *Taxation no Tyranny; an answer to the Resolutions and Address of the American Congress*, Samuel Johnson asked: 'How is it that we hear the loudest yelps for liberty among the drivers of the negroes?' Cited in James Boswell, *The Life of Johnson* (first published 1791, Penguin Books, 1984) 176.

⁵⁹ See Murphy, above n 27, 19–20.

⁶⁰ Pierre Rosanvallon, *The Society of Equals* (Arthur Goldhammer trans, Harvard University Press, 2013) 187 [trans of: *La société des égaux* (first published 2011)].

per cent surcharge was payable on investment income.⁶¹ In this peak era of social citizenship, it was not only the quantity of tax paid and distributed which was notable, it was also the quality of the discourse between government and taxpayer. The United Kingdom introduced pay as you earn (PAYE) towards the end of the Second World War.⁶² Basil Sabine outlines the massive communications exercise undertaken by the revenue authority in the lead-up to the introduction of PAYE, including broadcasts, articles for newspapers and periodicals, posters and branch offices established in very large factories – all done in the midst of a total war.⁶³

2 *Tax and Neoliberal Subjects*

Reduction of direct taxes is a badge of neoliberalism.⁶⁴ Notions of ‘trickle down’ and the notorious Laffer curve informed substantial cuts to income tax. Will Hutton denies that the Laffer curve had any ‘empirical or theoretical support’,⁶⁵ while John Galbraith doubts whether ‘anyone of sober mentality took Professor Laffer’s curve and conclusions seriously’.⁶⁶ The tax shortfall, especially in New Zealand, was made up through regressive indirect taxes. The term ‘taxpayer’ is often conflated with ‘income taxpayer’, even though, in, for example, the United Kingdom, personal income tax accounts for just 27 per cent of government revenue. The people who bear the burden of value added tax (VAT) (18 per cent) do not seem to be considered taxpayers.⁶⁷ In New Zealand, personal income tax may account for a greater proportion of government tax revenue (45.2 per cent) but goods and services taxes (GST), the VAT equivalent, accounts for 26.5 per cent of tax revenue.⁶⁸

3 *Tax in the New Millennium*

Having deregulated, reduced corporate taxes, permitted the free flow of capital, and encouraged multinational enterprise empowerment, it is no surprise that neoliberal countries should have found themselves embroiled in a race to the bottom. Consequently, in the new millennium, the Organisation of Economic Cooperation and Development (OECD) countries have focused their policy concerns on shoring

⁶¹ See T Clark, *The Limits of Social Democracy? Tax and Spend under Labour, 1974–79* (Working Paper 01/04, Institute of Fiscal Studies, London, 2001) <www.ifs.org.uk/wps/wp0104.pdf>. PAYE was introduced to New Zealand in 1958: see Rob Vosslamber, ‘How Much? Taxation on New Zealanders’ Employment Income 1893–1984’ (2009) 15 *New Zealand Journal of Taxation Law and Policy* 299 on New Zealand’s historical income tax rates.

⁶² See Basil Sabine, ‘The New Taxpayers Charter or Taxation without Tears’ (1991) *British Tax Review* 411.

⁶³ ‘PAYE was fully introduced in 1944 ... 15m people, anyone earning £100 a year or more, had received notices telling them their code number for the year upon which their cumulative tax deductions would be based.’ See David Gauke, ‘PAYE Story’ Taxation (21 September 2011) <www.taxation.co.uk/taxation/Articles/2011/09/21/29571/payee-story>. £250 would have constituted the upper limit of low incomes in the mid-1940s: see JR Hicks and UK Hicks, ‘The Incidence of Local Rates in Great Britain’ National Institute of Economic and Social Research Occasional Paper VIII (Cambridge University Press, 1945) 1.

⁶⁴ See Tabb, above 17, 3.

⁶⁵ See Will Hutton, *The World We’re In* (Little Brown, 2002) 103.

⁶⁶ See JK Galbraith, *The Culture of Contentment* (Sinclair-Stevenson, 1992) 10.

⁶⁷ See Murphy, above n 27, 28–9.

⁶⁸ See Bill English, ‘Budget at a Glance: Investing in a Growing Economy’ Treasury (2016) <www.treasury.govt.nz/budget/2016/at-a-glance/b16-at-a-glance.pdf>.

up their tax bases and preventing profit shifting by MNEs.⁶⁹ Parallel to government initiatives, the phenomenon of tax shaming by media and activist groups has emerged.⁷⁰

B Consumers and Taxpayers

Parallels can be drawn between the different conceptions of the consumer identified by Davies and conceptions of the taxpayer. One example is the parallel between the politicisation of consumption and activism against aggressive tax planning. The different phases of interaction may also be compared: pre-transaction (understanding one's tax obligations); transaction (taxpaying); post-transaction (expressing views on how tax revenues should be disbursed). Ultimately, both consumerism and taxpaying might involve participation in the formulation of policy and law.

We might say that consuming is as old as the human exchange of things, but 'the consumer' and 'consumerism' only came to policy prominence in the 1960s 'in response to challenges facing today's more affluent consumers'.⁷¹ Taxpayers have, of course, been around for millennia, and have been taken seriously as a subject of research at least since the time of Adam Smith's *Wealth of Nations* (1776). Consequently, comparisons of 'paradigmatic' treatment of taxpayers and consumers can only be painted with the boldest of brushstrokes. Davies identifies four levels of consumerism in a normative hierarchy, starting with protection, moving to information, then capability, and, finally motivation. Informing consumers (level 2) has a parallel in the massive communications exercises that were required to inform workers when they were brought into the income tax net with the introduction to PAYE. Having competent consumers (capability at level 3) is a requirement for the neoliberal ideal of markets being imagined everywhere. If citizens are conceived as consumers, then GST,⁷² as a tax on comprehensive consumption, is likely to constitute a significant element for the tax base. Finally, just as level 4 consumers are expected to be active in guarding their own and others' rights, so taxpayer activism has emerged as a significant phenomenon in the new millennium.

⁶⁹ For example, the United Kingdom's diverted profits tax, colloquially termed 'the Google tax': see HM Revenue & Customs, 'Diverted Profits Tax' (2014) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385741/Diverted_Profits_Tax.pdf>.

⁷⁰ See Vanessa Barford and Gerry Holt, 'Google, Amazon, Starbucks: The Rise of "Tax Shaming"' BBC News Magazine (21 May 2013) <www.bbc.com/news/magazine-20560359>. See below n 112 on much older forms of tax shaming.

⁷¹ Geraint Howells, Iain Ramsay and Thomas Wilhelmson, 'Consumer Law in Its International Dimension' in Geraint Howells, Iain Ramsay and Thomas Wilhelmson (eds) *Handbook of Research on International Consumer Law* (Edward Elgar, 2010) 1, 4.

⁷² Because GST is a tax on consumption, it might be argued that you 'choose' whether or not to pay it: see Richard A Epstein, 'Taxation in a Lockean World' in Jules Coleman and Ellen Frankel Paul (eds) *Philosophy and Law* (Basil Blackwell, 1987) 39 on 'Lockean taxation' corresponding with consumer choices. Frictionless taxpaying must be welcomed but, in the case of GST (typically around 20 per cent of government revenue), its invisibility disguises taxpaying and that invisibility discourages democratic debate about taxation.

Davies's inclusion of the descriptors 'solidaristic and communitarian'⁷³ and 'individualistic'⁷⁴ in level 4 motivation, which applies to citizen-consumers, may appear oxymoronic. But membership of postmodern society does not conform to strict binomials such as liberal/communitarian; rather people tend to oscillate between singular needs and community engagement. In a useful metaphor employed to interpret Gianni Vattimo's vision of contemporary society,⁷⁵ Heesok Chang likens our social existence to being passengers on a train, alone and yet, from time to time, thrown together.⁷⁶

According to Éric Maurin, '[t]here has been a tremendous reorganization of collective identities in recent years, as our sense of social proximity has fragmented.'⁷⁷ Nevertheless, as Pierre Rosanvallon says, in explaining his conception of equality of singularities:⁷⁸

If the meaning of a person's life lies in his difference from others, then he must coexist with them ... singularity binds a person to others. It does not set him apart. It arouses in others curiosity, interest, and a desire to understand. Equality of singularities does not imply "sameness".

Rosanvallon adds:⁷⁹

This form of equality defines a type of society whose mode of composition is neither abstract universalism nor identity-based communitarianism but rather the dynamic construction and recognition of particularity. This shift has significant implications. First it suggests that individuals now seek to participate in society on the basis of their distinctive rather than common characteristics. The value of singularity is thus directly social. Singularity is not a sign of withdrawal from society (individualism as retreat or separation). Rather, it signals an expectation of reciprocity, of mutual recognition.

We have, then, moved beyond traditional communitarianism (never to return) but we may also be moving beyond neoliberalism.

IV TAXPAYERS AS CITIZEN-CONSUMERS

This part of the article begins by presenting examples of actions which might be considered manifestations of citizen-consumerism in taxation. The examples range

⁷³ Expanding on 'solidaristic and communitarian', Davies, above n 7, 48–9 includes: altruism; ethical and sustainable consumption; communal interest; perceived effectiveness of action; wealth; trustworthiness of information source; and 'good guilt'.

⁷⁴ 'Individualism' includes: self-responsibility; personal safety; demand for quality and reduced cost; self-interest; and perceived effectiveness of action: see *ibid*.

⁷⁵ See, generally, Gianni Vattimo, *The Transparent Society* (David Webb trans, Johns Hopkins Press, 1992) [trans of: *La società trasparente* (first published 1989)].

⁷⁶ See Heesok, 'Postmodern Communities: The Politics of Oscillation' (1993) 4(1) *Postmodern Culture* <pmc.iath.virginia.edu/text-only/issue.993/review-3.993>.

⁷⁷ Cited by Rosanvallon, above n 60, 279.

⁷⁸ *Ibid*, 260–1.

⁷⁹ *Ibid*, 261.

from the dissemination of comprehensive analysis by tax academics and practitioners to demonstrations staged by activists as performance events.

A Examples

1 *Tax Justice Network*

The Tax Justice Network describes itself as:⁸⁰

an independent international network launched in 2003. We conduct high-level research, analysis and advocacy on international tax; on the international aspects of financial regulation; on the role of tax in society; and on the impacts of tax evasion, tax avoidance, tax 'competition' and tax havens. We seek to create understanding and debate, and to promote reform, especially in poorer countries. We are not aligned to any political party.

The Tax Justice Network may not be aligned to a particular political party, but it is not ideologically neutral, particularly in respect to its conception of the corporation and corporate duties. The dominant Anglo-American theory of the corporation, which is consonant with and implicated with neoliberalism, is based on an assumption of shareholder primacy.⁸¹ In this view, the corporation is a mere web of contracts, principally the contracts between directors and shareholders.⁸² The company is not a corporate citizen which might have moral obligations,⁸³ say, to refrain from aggressively avoiding tax.⁸⁴ The guiding function of directors, in this scheme, is to maximise shareholder returns, even if that requires bending or, possibly, breaking the law. In contrast, the corporate social responsibility movement, whose principles are consonant with the aims of the Tax Justice Network, sees the corporation as a corporate citizen.⁸⁵ The *Companies Act 2006* (UK) may move away from doctrinaire shareholder primacy by establishing an obligation on directors to take into account a broad range of stakeholders when considering the best interests of the company. Nevertheless, the principal directorial duty is 'to promote the success of the company for the benefit of its members [shareholders] as a whole'.⁸⁶ While the Tax Justice Network is persuasive in its view that directors

⁸⁰ See Tax Justice Network, 'Our Goals and Methods' <www.taxjustice.net/>.

⁸¹ See, generally, Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439.

⁸² See Daniel R Fischel, 'The Corporate Governance Movement' (1982) 35 *Vanderbilt Law School* 1259, 1273.

⁸³ See Frank H Easterbrook and Daniel R Fischel, 'Antitrust Suits by Targets of Tender Offers' *Corporate Governance Movement* (1982) 80 *Michigan Law Review* 1155, 1177.

⁸⁴ For counter arguments, see William B Barker, 'The Ideology of Tax Avoidance' (2009) 40(2) *Loyola University Chicago Law Journal* 229; Zoe Prebble and John Prebble, 'The Morality of Tax Avoidance' (2010) 43 *Creighton Law Review* 693.

⁸⁵ See, for example, Reuven Avi-Yonah, 'Corporate Social Responsibility and Strategic Tax Behavior' in Wolfgang Schön (ed) *Tax and Corporate Governance* (Springer, 2008) 183.

⁸⁶ *Companies Act 2006* (UK), s 172.

of United Kingdom companies do not have a fiduciary duty to avoid tax,⁸⁷ the wording of section 172 is sufficiently broad so as to permit aggressive tax planning.

When groups, such as the Tax Justice Network, promote progressively-biased arguments, they invite rebuttal from oppositely-aligned organisations, particularly those funded by Business Roundtables and libertarian foundations.⁸⁸

2 UK Uncut

Malcolm James describes UK Uncut as a ‘grass-roots pressure group ... which campaigns against the public spending cuts imposed by the Conservative-Liberal Democrat coalition government’.⁸⁹ UK Uncut came to prominence through its direct action in seeking to shame certain United Kingdom high street stores.⁹⁰ Either these companies or their principal shareholders had engaged in aggressive tax planning. Mostly young people used Web 2.0 media⁹¹ to arrange and publicise their demonstrations. In a more traditional approach, UK Uncut sought judicial review of a decision by the United Kingdom’s revenue service (HMRC) to waive national insurance contributions owed by Goldman Sachs. Although the move was ultimately unsuccessful, James concludes:⁹²

UK Uncut has been extremely successful in shaping public opinion, because, since it was founded in late 2010, there has been an upsurge of public interest in, and consciousness of, the tax arrangements of large companies and wealthy individuals, thus subjecting them to greater scrutiny. Similarly, HMRC has been called to account and the power relations which underpin the relationship between them and large companies.

The high street protests were disruptive,⁹³ but the long-term effectiveness of such performances,⁹⁴ which may alienate many ordinary people, must be questioned.⁹⁵

⁸⁷ See Farrer & Co LLP, ‘Fiduciary Duties and Tax Duties’ (2013) <www.taxjustice.net/cms/upload/pdf/Farrer_and_Co_Opinion_on_Fiduciary_Duties_and_Tax_Avoidance.pdf>.

⁸⁸ The New Zealand Business Roundtable, under the leadership of Roger Kerr, provided considerable intellectual impetus to libertarian ideology, with Richard Epstein, as a frequent guest lecturer, making a significant contribution.

⁸⁹ Malcolm David James, ‘Cutting a Good Deal: UK Uncut, Goldman Sachs and the Challenge to Administrative Discretion’ (2013) 14(3) *Journal of Applied Accounting Research* 248, 258.

⁹⁰ See, for example, the demonstrations in well-known shops on London’s Oxford Street available on You Tube at <<https://www.youtube.com/watch?v=ffYIE0ILBbI>>.

⁹¹ Web 2.0 technologies underpin platforms, such as Facebook, Wikipedia and Twitter, which enable their users to participate in online activities, rather than passively consume information produced by others: see, generally, Tim O’Reilly, ‘What is Web 2.0?’ in Michael Mandiberg (ed) *The Social Media Reader* (New York University Press, 2012) 32, 32–52.

⁹² James, above n 89, 263.

⁹³ See Ellie Mae O’Hagan, ‘A Moment that Changed Me – the Day I Discovered Protest’, *The Guardian* (online), 16 July 2015 <www.theguardian.com/commentisfree/2015/jul/16/moment-that-changed-me-direct-action-uk-uncut>.

⁹⁴ On protest as performance, see Pia Wiegink, *Protest EnACTed: Activist Performance in the United States* (Winter Verlag, 2011) 75–111.

⁹⁵ On the negative public reaction to the poll tax demonstrations in the United Kingdom, see Chris Rootes, ‘Shaping Collective Action: Structure, Contingency and Knowledge’ in Ricca

3 *Crickhowell Going Offshore*

Businesses in the small Welsh town of Crickhowell have emulated certain well-known British firms and MNEs to establish the town's own BEPS scheme.⁹⁶ Their object is to protest against and to demonstrate the ease of aggressive offshore tax planning. The Fair Tax Town campaign seeks to force government's hand in closing tax loopholes.⁹⁷ An implicit threat is that, if Crickhowell could 'move offshore', every town and business across the United Kingdom could follow.

4 *The Panama Papers*

In 2016, the International Consortium of Investigative Journalists (ICIJ) released the so-called Panama Papers, a massive leak of information about the Panamanian-based law firm Mossack Fonseca, its clients, and their involvement in tax evasion on a grand scale.⁹⁸ The first political casualty of these revelations was Iceland's Prime Minister, Sigmundur Davíð Gunnlaugsson, who resigned in the face of demonstrations against his concealment of offshore wealth.⁹⁹ Following the ICIJ leaks, in Australia, '1000 entities, involving hundreds of taxpayers – many of which include high-wealth individuals and their lawyers and accountants – [were] under investigation by the Australian Taxation Office'.¹⁰⁰

5 *Anti-tax Groups*

In contrast to the previously mentioned groups, whose fundamental aim is a progressive distribution of tax burdens, other groups wish to cap or reduce taxes. From a Marshallian perspective, it is submitted that these groups exercise their political citizenship but have no concern for the social aspects of citizenship. This conflict must be understood in the context of a simple fact about Western democracy: the poor and the young do not vote in the same proportions as do the wealthy and old.¹⁰¹ In the context of local government, this electoral vacuum

Edmonson (ed) *The Political Context of Collective Action: Power, Argumentation and Democracy* (Routledge, 1997) 81, 90–1.

⁹⁶ See Adam Sherwin, 'Crickhowell: Welsh Town Moves 'Offshore' to Avoid Tax on Local Business', *Independent* (online), 12 November 2015 <www.independent.co.uk/news/uk/crickhowell-welsh-town-moves-offshore-to-avoid-tax-on-local-business-a6728971.html>; Kimiko de Freytas-Tamura, 'Welsh Town Leads a British Revolt against the Tax System and Corporations' *The New York Times* (online), 21 February 2016 <www.nytimes.com/2016/02/21/world/europe/welsh-town-leads-a-british-revolt-against-the-tax-system-and-corporations.html?_r=0>.

⁹⁷ Fair Tax Town, 'Sign the Fair Tax Town Pledge' (2015) <<http://fairtaxtown.com/>>.

⁹⁸ International Consortium of Investigative Journalists, 'The Panama Papers' (2016) <<https://panamapapers.icij.or>>.

⁹⁹ Jon Henley, 'Iceland PM Steps Aside after Protests over Panama Papers Revelations', *The Guardian* (online), 5 April 2016, <www.theguardian.com/world/2016/apr/05/iceland-prime-minister-resigns-over-panama-papers-revelations>.

¹⁰⁰ Nassim Khadem, 'Australians with links to Panama Papers could be charged following raids this week' *The Sydney Morning Herald* (online), 6 September 2016 <www.smh.com.au/business/the-economy/australians-with-links-to-panama-papers-could-be-charged-following-raids-this-week-20160906-gr9sl0.html>.

¹⁰¹ In New Zealand, if current trends continue, by 2050, at least 40 per cent of people who vote in national elections will be aged 65 and older: see Jonathan Boston and Judith A Davey,

permits property owners to proscribe the scope of local democracy. California's Proposition 13, which limited increases in local taxes, is perhaps the pre-eminent instance of the propertied class asserting their taxation interests through a democratic process.¹⁰² Because the young and the poor do not tend to vote in local or national elections, taxation policy is likely to reflect the interests of older, propertied citizens who do vote. It is, therefore, unsurprising that anti-tax groups believe they might be able to influence tax policy, particularly at a local level.¹⁰³ One of these groups is the New Zealand Taxpayers Union, whose ostensibly uncontroversial goals include good fiscal governance. But another goal is 'to lower the tax burden on New Zealanders'.¹⁰⁴ The imperative of lowering the tax burden implies small government, the conservative Holy Grail.¹⁰⁵ Murphy pertinently asks whether these *soi-disant* 'alliances' or 'unions' have any mandate from or connection with taxpayers.¹⁰⁶

One of the key challenges faced by progressive civil groups is to present a united front in the way that conservative tax activists often do, notably in promoting a so-called flat tax. Thus, despite sharing the goal of just taxes, Murphy has criticised Crickhowell's Fair Tax Town, likening the initiative to 'protesting about street crime by going out to do some street crime: irresponsible'.¹⁰⁷ Sigmund Freud's 'narcissism of small differences' seems particularly relevant here.

'Politics of Ageing' in Jonathan Boston and Judith A Davey (eds) *Implications of Population Ageing: Opportunities and Risks* (Institute of Policy Studies, 2006) 363, 364.

¹⁰² See, for example, Kevin Drum, 'Happy 35th Birthday, Tax Revolt! Thanks for Destroying California', *Mother Jones* (online), 7 June 2013 <www.motherjones.com/kevin-drum/2013/06/tax-revolt-35th-anniversary-prop-13-california>.

¹⁰³ See, for example, the Auckland Ratepayers' Alliance, which describes itself as a 'coalition of individual Aucklanders and ratepayer groups dedicated to championing prudent fiscal management of our Super City': see Auckland Ratepayers' Alliance, 'About' <www.ratepayers.nz/about>. The Auckland Ratepayers' Alliance is, in fact, a company solely owned and directed by Jordan Williams, the chief executive of the New Zealand Taxpayers Union. Williams featured significantly in an exposé of right wing 'dirty politics': see Nicky Hager, *Dirty Politics: How Attack Politics Is Poisoning New Zealand's Political Environment* (Craig Potton Publishing, 2014).

¹⁰⁴ New Zealand Taxpayers Union, 'What We Stand for', <www.taxpayers.org.nz/what_we_stand_for>. The 'union' does not publish the identity of its sponsors>.

¹⁰⁵ The New Zealand Taxpayers Union is far less overt in its libertarian leanings than its inspiration, the United Kingdom's Taxpayers' Alliance: see The Taxpayers' Alliance, 'Our Mission' <www.taxpayersalliance.com/our_mission>.

¹⁰⁶ Murphy, above 27, 68.

¹⁰⁷ Quoted by Vanessa Houlder, 'Crickhowell Is the Town that Went Offshore', *Financial Times* (online), 13 November 2015 <www.ft.com/cms/s/0/911b609a-89f6-11e5-9f8c-a8d619fa707c.html#axzz3tbAXLPG0>. Murphy is the founder of the Fair Tax Mark, a private accreditation body: see Fair Tax, 'What's the Fair Tax Mark?' <www.fairtaxmark.net/what-is-it/>.

B Reservations about Activism

If, as communitarians hold, the community precedes the individual,¹⁰⁸ the interests of the community may trump the interests of individuals.¹⁰⁹ Indeed, community precedence may lead to oppression on grand and individual scales. Shaming, which can be both petty and severe, is particularly relevant in this regard.

1 Shaming

Amitai Etzioni observes that not only is shaming an archetypal sanction in strongly knit communities, but public humiliation may also represent a necessary step towards repentance and, ultimately, reintegration in the community.¹¹⁰ It is stressed that Etzioni contemplates traditional communities, such as church congregations; very few of us live today in such communities. In open communities, shaming is unlikely to work as restorative justice, especially in the digital age; the capacity of social media to disgrace others is unbounded. These media make stigmatisation easy, far reaching, and potentially devastating in its effects on the subjects of shaming.¹¹¹ Public humiliation, which has historically constituted a potent weapon in the armoury of social control,¹¹² is incompatible with the fundamental legal principles of proportionality and the rule of law.¹¹³

Martha Nussbaum presents plausible arguments against shaming.¹¹⁴ First, by humiliating a person, shaming offends their inalienable dignity.¹¹⁵ Second, shaming is a manifestation of ‘mob justice’; it is ‘not the impartial, deliberative, neutral justice that a liberal-democratic society typically prizes’.¹¹⁶ Third, shaming is an unreliable

¹⁰⁸ The essential difference between progressive liberalism and progressive communitarianism is that the former conceives of the rights-bearing individual as being prior to society: see Mulhall and Swift, above n 55, 45.

¹⁰⁹ Individual rights are plausibly incorporated into communitarianism theory; indeed, they may be more richly understood in the context of particular communities: see Philip Selznick, ‘The Communitarian Persuasion’ in Emiliios A Christodoulides (ed) *Communitarianism and Citizenship* (Ashgate, 1998) 15, 16.

¹¹⁰ See, generally, Amitai Etzioni, ‘Introduction’ in Amitai Etzioni and David E Carney (eds) *Repentance: A Comparative Perspective* (Rowman & Littlefield Publishers, 1997).

¹¹¹ See, for example, Jon Ronson, ‘“Overnight, Everything I Loved Was Gone”: The Internet Shaming of Lindsey Stone’, *The Guardian* (online), 21 February 2015 <www.theguardian.com/technology/2015/feb/21/internet-shaming-lindsey-stone-jon-ronson>.

¹¹² According to Johannes Voet, in the Dutch city states, those found guilty of tax fraud faced, along with financial or physical penalties, shaming-style sanctions ranging from loss of rank to permanent exile: see Johannes Voet, *Selective Voet* (ed and trans P E Gane, Butterworths, 1955–8) Book XXXIX, Title 4, Section 21. Bankrupts could also face shaming, being ostracised or exiled.

In contemporary China, shaming is a potent weapon of both the State and groups within society: see, for example, Xiaoming Chen, ‘Social Control in China: Applications of the Labeling Theory and the Reintegrative Shaming Theory’ (2002) 46(1) *International Journal of Offender Therapy and Comparative Criminology* 45.

¹¹³ See Philip A Joseph, *Constitutional and Administrative Law in New Zealand* (Brookers, 3rd ed, 2007) 945; Tom Bingham, *The Rule of Law* (Penguin Books, 2011) 66–84.

¹¹⁴ Martha C Nussbaum, *Hiding from Humanity: Disgust, Shame, and the Law* (Princeton University Press, 2004) 230–7.

¹¹⁵ *Ibid*, 230.

¹¹⁶ *Ibid*, 234.

form of punishment.¹¹⁷ Justice is necessarily informed by proportionality, whereas humiliating someone may result in ‘calibrating inaccurately the magnitude of the penalty’.¹¹⁸ Fourth, shaming is not necessarily an effective deterrent. People who suffer humiliation at the hands of the dominant group may become more alienated than before, leading to the possibility of sub-groups being attracted by the stigma imbued by hegemonic groups. Nussbaum’s concerns lie with disadvantaged groups, but the already socially distant elite can also be further alienated by stigmatisation and may, for example, become tax exiles.

Opposition to shaming is, in essence, about maintaining human dignity and promoting social inclusion. Since corporations do not have human dignity,¹¹⁹ Julia Annas and Deborah Rhode are persuasive when they argue that shaming juristic persons is different from shaming people, and may be an appropriate legal and social sanction.¹²⁰ Concerned with its image, Starbucks made a voluntary corporate tax payment of £15 million, and transferred its European headquarters from low-tax Amsterdam to London – effectively assuming a higher tax burden as a public relations exercise.¹²¹

Corporations should, nevertheless, expect proportionate sanctions. It may also be noted that the corporate veil may be ignored and individuals behind the corporation vilified.¹²² The nature of a corporation is too complex an idea to be considered here, but, if the law makes a corporation a juristic person, that entity ought to be subject to the rule of law.¹²³

¹¹⁷ Attempts by the liberal media to disgrace Donald Trump for his tax planning were unsuccessful and seem to have contributed to his image as a shrewd leader. See Sophia Tesfaye, ‘All of Donald Trump’s apologists: Rudy Giuliani, Chris Christie argue that avoiding taxes makes him a “genius”’ Salon (4 October 2016) <www.salon.com/2016/10/03/all-of-donald-trumps-apologists-possible-tax-avoidance-makes-trump-a-genius-rudy-giuliani-chris-christie-argue/>.

¹¹⁸ Nussbaum, above n 114, 235.

¹¹⁹ Delivering a unanimous decision of the South African Constitutional Court, Langa DP, said in *Investigating Directorate: SEO v Hyundai Motor Distributors (Pty) Ltd* 2001 (1) SA 545, [18]: ‘Juristic persons are not the bearers of human dignity.’

¹²⁰ Cited by Nussbaum, above n 114, 244.

¹²¹ Vanessa Houlder, ‘Starbucks European Unit Pays \$15m UK Tax’ *Financial Times* (online ed, 29 June 2016) <<https://www.ft.com/content/5222fd14-3d3b-11e6-9f2c-36b487ebd80a>>.

¹²² See, for example, the conflation of Philip Green and British Home Stores plc, as seen in Matt Hunter and Sam Tonkin, ‘Sir Shifty carries on cruising while last stores close: Former BHS boss Philip Green suns himself on his £100million super yacht as the department store he’s accused of sinking disappears from the High Street after 88 years’ *The Daily Mail* (online), 29 August 2016 <www.dailymail.co.uk/news/article-3762304/After-88-years-BHS-finally-disappears-today.html#ixzz4QtVTveJg>. The point is not to condone directorial malfeasance but to ensure that it is proportionately punished in accordance with the rule of law.

¹²³ Mark Bovens argues that, since due process was developed to protect individuals against arbitrary behaviour on the part of the agents of the omnipotent state, due process should not be extended to large organisations as they are not similarly weak in relation to the State: see Mark Bovens, ‘The Corporate Republic: Complex Organizations and Citizenship’ in Emiliós A Christodoulides (ed) *Communitarianism and Citizenship* (Ashgate, 1998) 158, 162. It would, however, weaken the procedural elements of the rule of law if juristic persons, which may hold property in their own names, did not have full access to the courts: see *First National Bank of South Africa v Commissioner, SARS* 2002 (4) SA 768 (Constitutional Court).

2 *Activism to Slacktivism*

The Internet has transformed activism, notably through online petitions organised by groups, such as MoveOn.¹²⁴ But such ‘clicktivism’ or, more pejoratively, ‘slacktivism’,¹²⁵ is controversial. Micah White, a co-founder of Occupy Wall Street, has, for example, criticised clicktivism for its use of marketing methodology and its dilution of the impact of direct action.¹²⁶ Well-considered activism can influence individual and corporate behaviour, including taxpaying,¹²⁷ but the place of cyber-vigilantes in civil society is problematic.

3 *Corporate Co-option*

Online activist organisations, such as MoveOn, may emulate business models in ways that offend some grassroots activists,¹²⁸ but businesses, notably Uber and Airbnb, which have access to millions of customers and suppliers, may conversely emulate online activists.¹²⁹ The possibility becomes real of political discourse, including proposals for local taxes on hotel beds, being co-opted by business interests. Despite having the veneer of citizen participation, Uber and Airbnb are able to flood the market place of ideas by harnessing the self-interest of their drivers or hosts. Thus, Conor Dougherty and Mike Isaac report:¹³⁰

Now, as cities grapple with the growth of [Uber and Airbnb] and try to pass rules for how they should operate, the companies are fighting back by turning their users into a vast political operation that can be mobilized at any sign of a threat.

V POLICY RECOMMENDATIONS AND CONCLUSION

This part of the article makes tentative policy recommendations and draws conclusions.

¹²⁴ See MoveOn, ‘What Is MoveOn.org?’ <<http://front.moveon.org/about/#.Vmdz4Tahd54>>.

¹²⁵ ‘Actions performed via the Internet in support of a political or social cause but regarded as requiring little time or involvement (eg signing an online petition or joining a campaign group on a social media website’: see Oxford Dictionaries, ‘Slacktivism’ (2015) <www.oxforddictionaries.com/definition/english/slacktivism>).

¹²⁶ See Micah White, ‘Activism after Clicktivism’ Q (2014) <<http://qideas.org/articles/activism-after-clicktivism/>>.

¹²⁷ See, for example: John Gellemore, Edward L Maydew and Jacob R Thornock, ‘The Reputational Costs of Tax Avoidance’ (2014) 31(4) *Contemporary Accounting Research* 1003; Scott D Dyreng, Jeffrey L Hoopes and Jason H Wilde, ‘Public Pressure and Corporate Tax Behavior’ (WP14/16, Oxford University Centre for Business Taxation, 2014).

¹²⁸ See White, above n 126.

¹²⁹ See Issie Lapowski, ‘Uber’s New Fake Feature Derides Regulators’, *Wired* (online), 16 July 2015 <www.wired.com/2015/07/uber-de-blasio/>.

¹³⁰ Conor Dougherty and Mike Isaac, ‘Airbnb and Uber Mobilize Vast User Base to Sway Policy’, *The New York Times* (online), 4 November 2015 <www.nytimes.com/2015/11/05/technology/airbnb-and-uber-mobilize-vast-user-base-to-sway-policy.html?_r=0>.

A Policy Recommendations

The least controversial policy recommendations will be considered first (constituencies for fiscal information, and consultation); then the more problematic issues of engaging with activists and tax education.¹³¹

1 Constituencies for Fiscal Information

Government agencies collect considerable fiscal information which, subject to privacy concerns, should be made available to the public to foster discourse. One of the difficulties faced in this regard lies with making information comprehensible and useful to the widest audience. (A large body of literature exists on the issue of usefully communicating financial information; much has been published in the journal *Accounting, Auditing & Accountability*.) Potential also exists for non-engagement and apathy. In 2014, the United Kingdom's revenue authority posted a leaflet to 30 million taxpayers explaining how their income tax and national insurance contributions were used.¹³² Two-thirds of taxpayers later surveyed could not recall receiving the summary. Nevertheless, of the remainder, 75 per cent found the explanation of tax useful, and 60 per cent considered the explanation of government expenditure helpful.¹³³

The World Bank has long urged governments to promote constituencies for fiscal information.¹³⁴ But this laudable proposal is not unproblematic. In particular, a government-funded body charged with disseminating tax information would find it difficult to present information in a useful but politically neutral way. Indeed, one of the perceptions of the United Kingdom revenue authority's information exercise was that the authority had been politicised.¹³⁵

2 Consultation

Consultation is an uncontroversial element in the development of contemporary tax policy.¹³⁶ New Zealand has instituted a well-regarded generic tax policy process (GTPP).¹³⁷ But the GTPP tends to be dominated by submissions made by the New

¹³¹ This article is about the relationship between government and taxpayers. The content of substantive tax laws lies beyond the scope of the article.

¹³² It is not obvious why details of VAT revenue, which accounts for approximately one-fifth of United Kingdom exchequer receipts, were not included. But see above n 67 on the common exclusion of VAT-payers from the conception of 'the taxpayer'.

¹³³ See Adam Palin, 'Tax Statements Sent out to an Apathetic Public', *Financial Times* (London), 7 November 2015, 3.

¹³⁴ See Deepa Narayan (ed), *Empowerment and Poverty Reduction: A Sourcebook* (World Bank, 2002).

¹³⁵ See Palin, above n 133, 3.

¹³⁶ Michael Cadesky, Ian Hayes and David Russell, *Towards Greater Fairness in Taxation: A Model Taxpayer Charter Preliminary Report* (AOTCA, CFE and STEP, 2013) 184.

¹³⁷ For an overview of the GTPP, see Adrian J Sawyer, 'Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation – Some Recent Developments' (1996) 2 *New Zealand Journal of Taxation Law and Policy* 17. For a concise, plain language overview of the GTPP, see Peter Dunne, 'Keynote Address to EMA Annual Payroll Conference' (2013) <<http://beehive.govt.nz/speech/keynote-address-ema-annual-payroll-conference>>. For a critical review of the GTPP in practice, see Peter Vial, 'The Generic Tax Policy Process: A

Zealand Law Society, Chartered Accountants Australia and New Zealand, large law firms and accounting practices, and, depending on the issue, special interest business groups. As consultation, it has a narrow practical focus. Ideally, we all would be involved in tax discourse, but, in practice, which individuals and civic groups have the time and resources to contribute to developing tax policy? Conversely, when only a few members of civil society are engaged, debate may become skewed.¹³⁸ Tax is seen as a technocratic preserve. When democratically-elected representatives fail to heed the wisdom of professional technocrats, they may be dismissed as 'tax prats'. Contemplating this technocratic dismissal of non-experts from tax policy discourse, Wendy Bradley observes '[t]he outsider, the tax prat, might think there is a simple syllogism, that is, tax is governed by law, laws are made, the people making them have set simplicity as a priority objective, therefore tax law will become simpler via their actions.'¹³⁹

3 *Activism*

Following Davies, European Union policymakers have sought to empower the citizen-consumer. It is submitted that this advanced stage of consumerism is also seen in the behaviour of taxpayers. The research-based activism of the Tax Justice Network seems to reflect an ideal of citizen empowerment expressed in rational discourse. But was the pro-tax activists' disruption of shoppers on London's Oxford Street or the small businesses of Crickhowell taking their profits offshore part of the Brussels-based policymakers planned and executed policies for consumer-citizenship? So, policymakers must ask: to what extent is citizenship-consumerism an organic phenomenon that may resist shaping by government? Indeed, to what extent should government be wary of activism?

4 *Tax Education*

Murphy argues that taxation should be a compulsory subject for schools, implicitly, in the way that Civics is taught in the United States. Support for democracy is near universal but, in essence, Murphy argues that progressive taxation is as equally uncontroversial as democracy. But, for plausible and honest reasons, others would dispute that assumption. Taxation is not a cold science: it is, in its nature, political and partisan, and one must be sceptical that it could be taught without ideological inflection in the school classroom.

"Jewel in our Policy Formation Crown"?' (2012) 25(2) *New Zealand Universities Law Review* 318.

¹³⁸ In New Zealand, for example, the well-endowed Morgan Foundation has gained publicity for its proposal for an arguably Quixotic form of capital taxation: see Andrew Laxton, 'Gareth Morgan's Big Tax Idea' *The New Zealand Herald* (online), 1 October 2011 <www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10755689>.

¹³⁹ Mike Truman, 'Tax Prat of the Year' *Taxation* (6 February 2013) <www.taxation.co.uk/Articles/2013/02/06/53361/tax-prat-year>; Wendy Bradley, 'Tax Prats and Citizen Stakeholders: Professionalism in the Gap Between Tax Priority Setting and Tax Policymaking' (2015) 24(2) *Social and Legal Studies* 203, 220.

B CONCLUSION

This article is exploratory in nature, and has considered the applicability of the emerging model of the citizen-consumer to taxpayers. Despite the promise of citizen-consumer activism in the field of tax law and policy, reservations have been noted. Some of the main tools of tax activism – performance protest and shaming – can be disproportionately harmful both to the cause of social justice and the subjects of shaming. Co-option of online activism by corporate interests is also a concern. In an ideal discursive democracy, citizens would actively participate in the formulation of the policy and laws under which they contribute to and benefit from the public treasury.¹⁴⁰ Web-based technology ostensibly promotes this ideal, but the reality is more complex. Distinctions between protest and consumption, and between business and consumer interests, become increasingly difficult to maintain. Consequently, any policy recommendations must be tentative, and conclusions uncertain.

The research of Davies in relation to consumerism and citizenship, and that of Rosanvallon on singularity and equality are not well known among Australasian tax academics.¹⁴¹ Nevertheless, their ideas have relevance beyond their source and immediate context of the European Union. Both examine the structural changes in the relationship between citizens and the State and citizenship. These changes in developed countries, from social citizenship to neoliberalism and beyond, are equally relevant to New Zealand and Australia. It must be conceded that the authors' conceptualisation of citizenship are, to some degree speculative; nevertheless, in the field of taxation, they suggest ways for both citizens and the State to engage with the power of MNEs.

¹⁴⁰ See, generally, Jonathan Barrett, 'Communities of Taxation and Justice: A Communitarian Approach to Inequality and Taxation' (2012) *Journal of Applied Law and Policy* 1.

¹⁴¹ I am grateful to Miranda Stewart for alerting me to the work of Pierre Rosanvallon.

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UNIVERSITY STUDENTS AND TAX LITERACY: OPPORTUNITIES AND LESSONS FOR TAX TEACHING*

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ABSTRACT

Financial literacy is important due to the growing complexity of financial products, increases in life expectancy and reliance on self-funded retirement support.¹ Previous research has identified that aspects of tax and superannuation form part of overall financial literacy, and that there are gaps in the understanding of some of these concepts which could lead to poor financial decisions.² This paper reports on a recent survey of Australian university students and their perceptions of the importance of financial literacy, the extent to which they had been taught financial literacy at school, and their level of understanding of some basic tax and superannuation concepts. The results of the survey highlight the importance of taxation as a component of financial literacy, opportunities for cross-disciplinary tax teaching and insights for tax teaching and advisor training more broadly.

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¹ OECD, *Improving Financial Literacy: Analysis of Issues and Policies* (OECD Report, 2005).

² Toni Chardon, 'Taxation and Superannuation Literacy in Australia: What do people know (or think they know)?' (2014) 1 *JASSA: The Finsia Journal of Applied Finance* 42, 7.

I INTRODUCTION

Improving the financial literacy of the Australian population is currently high on the Government's agenda. A revised National Strategy for Financial Literacy was released for the period 2014—2017, and a National Stakeholder Forum was held in November 2015.¹ The National Strategy is important in the context that:

In today's fast-paced consumer society, financial literacy is an essential everyday life skill. It means being able to understand and negotiate the financial landscape, manage money and financial risks effectively and avoid financial pitfalls.²

The Australian Government has suggested that improving financial skills and providing financial education is central to economic prosperity, and that low levels of financial literacy act as a barrier to participation in the financial system.³ In recent times, many investors and retirees have been faced with economic circumstances that have impacted on their life savings and superannuation balances. The financial literacy of consumers, financial decision making, advisor--client relationships, and the impact of all of these on increased wealth and economic prosperity is therefore an important area of research.

Previous studies of financial literacy in Australia have found that the financial knowledge of younger people tends to be lower, and they are therefore at risk for less-than-optimal financial decision making.⁴ Chardon has previously argued that basic concepts of tax and superannuation literacy should form part of any measurements of overall financial literacy, and that tax literacy also tends to be lower for those in younger age groups.⁵ This article reports on the tax literacy findings from a 2015 financial literacy survey of university students, specifically those participants aged 20 years or younger. The first part gives an overview of financial and tax literacy research in Australia; the second part gives an overview of financial literacy research specifically in the context of university students; the third part sets out methodology and presents the results and analysis of the current survey. The findings from this analysis are explored to determine whether there

¹ Australian Securities and Investments Commission, *National Financial Literacy Strategy* (2014) 2, <www.financialliteracy.gov.au/media/546585/report-403_national-financial-literacy-strategy-2014-17.pdf>.

² Ibid.

³ Commonwealth Department of Treasury, *The National Strategy for Consumer and Financial Literacy* <<http://cfltaskforce.treasury.gov.au/content/terms.asp?NavID=2>>.

⁴ ANZ, *ANZ Survey of Adult Financial Literacy in Australia* (AC Nielsen Report 2005); ANZ, *ANZ Survey of Adult Financial Literacy in Australia* (The Social Research Centre Report 2008); ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2011 ANZ Survey* (The Social Research Centre Report 2011); Diana Beal and Sarath Delpachitra, 'Financial Literacy amount Australian university students' (2003) 22(1) *Economic Papers: a Journal of Applied Economics and Policy* 65.

⁵ Toni Chardon, 'Taxation and Superannuation Literacy in Australia: What do people know (or think they know)?' (2014) 1 *JASSA: The Finsia Journal of Applied Finance* 42.

are any impacts on the current tax teaching curriculum or further opportunities for financial and tax literacy education programs at universities.

II FINANCIAL AND TAX LITERACY OVERVIEW

In this article, 'financial literacy' is defined as 'the ability to make informed judgements and to make effective decisions regarding the use and management of money'.⁶ The importance of financial literacy lies in the potential difficulty arising from suboptimal financial decision making, as acknowledged by the Organisation for Economic Co-operation and Development (OECD) in the context of the global financial crisis:

the lack of understanding of households on financial issues and, in particular, on credit and investment, has also a major role. As a result, individuals have accepted (sometimes unknowingly) to support more financial risk than what they could afford.⁷

The notion of financial literacy has expanded over the last decade, with greater focus on a combination of knowledge, behaviour, confidence and attitudes.⁸ Internationally, 'financial capability' is a more common term used in the literature.⁹ Although financial literacy is now an embedded term in Australia, given the National Strategy, this broadening of concepts has been seen in the ANZ National Surveys of Adult Financial Literacy in Australia, which have acknowledged that financial literacy 'is a complex combination of a person's skills, knowledge, attitudes and ultimately their behaviours in relation to money'.¹⁰

It has been argued that an increase in the availability of financial products has led to an increasingly complex market for consumers.¹¹ There is also an increased focus by governments on self-funded retirement, and evidence suggesting certain at-risk

⁶ ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2014 ANZ Survey* (The Social Research Centre, 2015); Financial Literacy Foundation, *Financial Literacy – Australians Understanding Money* (Commonwealth Treasury, 2007).

⁷ International Network for Financial Education, *Financial Education and the Crisis – Policy Paper and Guidance* (OECD, 2009), 4.

⁸ E Kempson and S Collard and N Moore, *Measuring financial capability: an exploratory study*, Consumer Research Report 37 (Personal Finance Research Centre, 2005); Johanna Leskinen and Anu Raijas, *Consumer Financial Capability – A life cycle approach* (November 2005) <http://static.twoday.net/fes/files/FES_FinEd_Finland_lifecycleapproach.pdf>; Andrew Worthington, 'Predicting Financial Literacy in Australia' (2006) 15(1) *Financial Services Review* 59.

⁹ Jeanne M Hogarth, 'Financial literacy and family and consumer sciences' (2002) 94(1) *Journal of Family and Consumer Sciences* 14; Kempson, and Collard and Moore, above n 8.

¹⁰ ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2014 ANZ Survey*, above n 6, 1; ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2011 ANZ Survey*, above n 4, 2.

¹¹ Worthington, above n 8.

groups have low levels of financial literacy particularly in relation to financial products and superannuation.¹²

The ANZ 'Survey of Adult Financial Literacy in Australia' is the most widely cited measurement of financial literacy in Australia and has been conducted over a number of years.¹³ The surveys have consistently reported that Australians are broadly financially literate when it comes to basic concepts such as budgeting and saving, but that certain demographic groups -- such as females, those with less education, those not in employment, and those with lower incomes -- have lower levels of literacy, and more complex financial concepts are not as well understood or utilised by these groups.¹⁴ Further, all population groups tend to find superannuation concepts more difficult than basic financial concepts such as banking.¹⁵

Previous research by Chardon has argued that financial literacy frameworks need to include an understanding of basic taxation and superannuation concepts that impact on day-to-day financial decision making, financial obligations and effective communication with advisors.¹⁶ Taxation and superannuation are usually poorly covered in financial literacy surveys and education programs. Chardon, reporting the results of an adult survey of tax literacy in Australia, found that 19 per cent of Australians had tax literacy scores classified as either 'poor' or 'low'. Further, certain demographic groups with low financial literacy (females, younger age categories and less employment) were also likely to have lower levels of tax literacy.¹⁷

Recently, Australia participated in a trial of the financial literacy assessment framework as part of the OECD Programme for International Student Assessment (PISA) survey. Australian students performed relatively well (ranked 4th of 18 participating countries).¹⁸ The OECD Financial Literacy Assessment Framework specifically recognised that the financial landscape incorporates an understanding of the 'consequences of changes in economic conditions and public policies, such as changes in interest rates, inflation, and taxation or welfare benefits'.¹⁹ Similarly, the 2008 ANZ Adult financial literacy survey recognised the potential for tax to be a component of a financial literacy framework when it stated:

¹² ANZ, above n 6; ANZ, *ANZ Survey of Adult Financial Literacy in Australia 2008*, above n 4; ANZ, *ANZ Survey of Adult Financial Literacy in Australia 2005*, above n 4.

¹³ ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2011 ANZ Survey*, above n 4; ANZ, *ANZ Survey of Adult Financial Literacy in Australia* (The Social Research Centre, 2008), above n 4; ANZ, *ANZ Survey of Adult Financial Literacy in Australia 2005*, above n 4; ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2014 ANZ Survey*, above n 6.

¹⁴ ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2011 ANZ Survey*, above n 4; ANZ, *ANZ Survey of Adult Financial Literacy in Australia 2008*, above n 4.

¹⁵ *ANZ Survey of Adult Financial Literacy in Australia 2005*, above n 4, 2.

¹⁶ Toni Chardon, 'Weathering the Storm: Tax as a Component of Financial Capability' (2011) 5(2) *Australasian Accounting Business and Finance Journal* 53.

¹⁷ Chardon, above n 5.

¹⁸ OECD, *PISA 2012 Results: Students and Money: Financial Literacy Skills for the 21st Century* Volume VI (OECD 2014).

¹⁹ OECD, *PISA 2012 Financial Literacy Assessment Framework* (PISA Report) (OECD, April 2012) 18 <www.oecd.org/pisa/pisaproducts/46962580.pdf>.

Please note that other potential aspects of adult financial literacy (eg taxation; understanding of how and why government is financed; awareness and understanding of government benefits; understanding of how fees are calculated and how to minimise them) were agreed upon as being beyond the scope of the current project, and therefore not included in the framework.²⁰

As stated earlier, the most recent National Financial Literacy Strategy has a number of priorities. The strategic priorities relevant to the research presented in the present article are the first priority (educate the next generation, particularly through the formal education system) and the fifth – (improve research, measurement and evaluation).²¹ Accordingly, this article proposes ways in which the next generation, particularly university students, may be better financially educated, and also provides empirical evidence that adds to the research in this field.

III FINANCIAL LITERACY: YOUNG PEOPLE AND UNIVERSITY STUDENTS

Over the years, adult financial literacy research conducted in Australia by ANZ has consistently found that younger age groups (under 25 years) tend to have the lowest financial literacy scores. This was confirmed in the most recent survey, which also found lower scores in behavioural indicators such as planning ahead and choosing financial products.²² Further, younger people were also the most likely group to have obtained financial information or advice from family or friends (65 per cent).²³ A 2007 Australian survey of young people between the ages of 12 and 17 found that they were less confident than adults when it came to managing money and that they were most likely to gain their information and advice from family.²⁴

More recently, a survey of 207 Australian year 11 school students found there was lower financial literacy in the areas of financial risk awareness and consumer rights when compared with financial decision making.²⁵ The majority of participants also agreed (70 per cent) that learning more about financial management was important. The authors suggest that ‘some groups of young people have lower levels of financial literacy and therefore are more vulnerable to poor decision making’.²⁶

One of the most widely cited surveys of university students’ financial knowledge was that of Beal and Delpachitra.²⁷ This survey preceded all of the international government strategies for financial literacy, yet similarly found there was evidence

²⁰ ANZ, *ANZ Survey of Adult Financial Literacy in Australia – Final Report 2003* (The Social Research Centre, 2008), above n 4, 182.

²¹ Australian Securities and Investments Commission, above n 1.

²² ANZ, above n 6.

²³ *Ibid.*

²⁴ Financial Literacy Foundation, above n 6, 57.

²⁵ Paul Ali et al, ‘The Financial Literacy of Young Australians: An Empirical Study and Implications for Consumer Protection and ASIC’s National Financial Literacy Strategy (2014) 32(5) *Company and Securities Law Journal* 334.

²⁶ *Ibid* 352.

²⁷ Beal and Delpachitra, above n 4.

of low financial skill and knowledge among university students and recommended that comprehensive secondary and primary school education programs be developed.²⁸

A 2009 survey of the financial literacy of 472 Australian university students found that there were low levels of financial literacy overall, and that this was impacted by a range of variables depending on the specific area of financial knowledge tested.²⁹ This survey is one of very few in Australia that has included or measured understandings of tax and superannuation. Here, the survey found that only 29.5 per cent of participants correctly understood the difference between a tax offset and a deduction, and that this was only marginally higher among business students (34.5 per cent correct).³⁰ The authors concluded that it cannot be 'assumed that university students, even business students are immune from financial illiteracy'.³¹

In examining financial literacy of young people in the United States, Lusardi, Mitchell and Curto argued that the increasing debt load of younger persons from either secondary school or university is of concern, particularly when coupled with financial illiteracy.³² In the United States, financial literacy education programs in the form of general education courses within universities are more common than in Australia. Due to the style of learner, their interest and engagement, it has been argued that programs at the college (university) level have better outcomes for particular aspects of financial literacy than those in high school.³³ Crain undertook a review of 308 universities that offer financial literacy courses and found that although only 37 of the schools allowed the particular course to be taken as a general elective by all students, there was substantial support, among academic staff, for their availability.³⁴ The review concluded that successful implementation of financial literacy initiatives required motivated discipline leaders, nevertheless programs were often difficult to introduce due to university politics and competition among disciplines.³⁵ Similar arguments could be made in relation to competing disciplines in university accounting programs. It is therefore important to be able to demonstrate, with empirical evidence, that concepts such as financial literacy should be included because of their social and economic importance.

Research by Palm and Bisman has argued that introductory accounting courses at university could benefit from more constructive alignment of objectives and development of generic skills if they are to remain relevant in a modern accounting

28 Ibid.

29 Michelle Cull and Diana Whitton, 'University Students' Financial Literacy Levels: Obstacles and Aids' (2011) 22(1) *The Economic and Labour Relations Review* 99.

30 Ibid.

31 Ibid 112.

32 Annamaria Lusardi, Olivia S. Mitchell and Vilsa Curto, 'Financial Literacy among the Young' (2010) 44(2) *Journal of Consumer Affairs* 358.

33 Tzu-ChinMartina Peng et al, 'The Impact of Personal Finance Education Delivered in High School and College Courses' (2007) 28(2) *Journal of Family and Economic Issues* 265.

34 Susan J. Crain, 'Are universities improving student financial literacy? A study of general education curriculum' (2013) 39(1/2) *Journal of financial education* 1.

35 Ibid.

environment.³⁶ Similarly, Freudenberg and Boccabella have argued that accounting curricula need to reflect current industry practices (specifically in relation to the popularity of trusts and SMSFs) if they are to remain relevant and useful for practitioners.³⁷ The present study therefore provides valuable evidence for academics designing tax, financial and accounting education courses at university level, as it provides background of the learner in the context of financial literacy as well as providing evidence useful for training students in communicating with clients.

A Methodology

As noted, previous financial literacy studies have found that financial literacy tends to be lower in younger age groups. This study aimed to explore levels of financial literacy among university students as well as their perception of the financial education they received in high school. Previous research has explored the financial literacy of university students at a particular university. This survey was distributed across four Australian universities as well as being shared through social media.³⁸ The use of social media to distribute surveys is argued to be valid notwithstanding its limitations.³⁹

The survey asked both subjective and objective questions in relation to the following financial literacy concepts: general interest, inflation, investment, budgeting and saving, insurance, superannuation and taxation. In all, fourteen literacy questions went towards an overall financial literacy score. A subset of four specific tax knowledge questions are the focus of analysis in this paper. The questions were drawn from a range of existing research on financial literacy with some modifications for the age of participants and the Australian context.⁴⁰

Previous research has highlighted the importance of confidence as a critical aspect of building financially capable populations.⁴¹ Indeed, previous tax literacy research has found that females, those in younger age groups and those on lower incomes tend to be less confident when it comes to taxation and superannuation issues

³⁶ Chrisann Palm and Jayne Bisman, 'Benchmarking Introductory Accounting Curricula: Experience from Australia' (2010) 19(1-2) *Accounting Education* 179.

³⁷ Brett Freudenberg and Dale Boccabella, 'Changing Use of Business Structures: Have University Business Law Teachers Failed to Reflect this in their Teaching?' (2014) 9(1) *Journal of the Australasian Tax Teachers Association* 180.

³⁸ Beal and Delpachitra, above n 4; Cull and Whitton, above n 29.

³⁹ Christine Brickman-Bhutta, 'Not by the Book: Facebook as Sampling Frame' (2012) 41(1) *Sociological Methods and Research* 57.

⁴⁰ ANZ, *ANZ Survey of Adult Financial Literacy in Australia 2008*, above n 4; Hazel Bateman et al, 'Financial Competence and Expectations Formation: Evidence from Australia*' (2012) 88(280) *Economic Record* 39; Chardon, above n 5; Annamaria Lusardi and Olivia S Mitchell, *Financial Literacy and Retirement Preparedness: Evidence and implications for financial education programs* (Michigan Retirement Research Center Research Paper No. WP 2006-144, 2006); Chrisann Palm, *Financial Literacy and Superannuation Investment Decision-making in a choice environment: An exploratory study* (PhD Thesis, Queensland University of Technology, 2014) <<http://eprints.qut.edu.au/78464/>>.

⁴¹ Levon Blue and Mark Brimble, 'Reframing Expectations of Financial Literacy: Bringing Back the Reality' (2014) 1 *JASSA: The Finsia Journal of Applied Finance* 37.

specifically.⁴² Acknowledging the difference between self-rating of understanding and confidence, the current survey asked participants to self-rate their understanding of particular financial concepts. The self-rating of taxation understanding by participants will therefore be analysed in this paper in the context of actual levels of understanding of taxation concepts.

B Descriptive Statistics

The survey was conducted between May and July 2015. The next part presents the specific tax literacy results of the survey along with relevant statistical analysis. The sample size for participants aged 20 years or under was 297 with 165 (55.6 per cent) complete responses (over 70 per cent missed one or no questions). The analyses were conducted using SPSS22 with pairwise deletion of responses with missing data, unless indicated otherwise.

Table 1: Summary Statistics of Variables (N=297)

Variable (n)	Category	Count (% of n)
Gender (209)	Male	41 (19.6)
	Female	168 (80.4)
Employment (208)	Full time	7 (3.4)
	Part time	39 (18.8)
	Casual	89 (42.8)
	Other modes	15 (7.2)
	Not working	56 (26.9)
	Never worked	2 (1.0)
Self-rating of Tax knowledge (267)	Very low	69 (25.8)
	Low	102 (38.2)
	Fair	62 (23.2)
	High	23 (8.6)
	Very high	11 (4.1)
Question 1 (236) Taxation of Superannuation	Correct	87 (36.9)
	Incorrect	149 (63.1)
Question 2 (220) Calculating Assessable Income	Correct	44 (20.0)
	Incorrect	176 (80.0)
Question 3 (220) Calculating Tax Payable	Correct	125 (56.8)
	Incorrect	95 (43.2)
Question 4 (297) Negative Gearing Meaning	Correct	52 (17.5)
	Incorrect	245 (82.5)
Overall Tax Score (220)	0	51 (23.2)
	1	75 (34.1)
	2	60 (27.3)
	3	29 (13.2)

⁴² Toni Chardon, *Taxation as a component of financial literacy – How literate are Australians in relation to taxation?* (PhD Thesis, Griffith University, 2014).

	4	5 (2.3)
ATAR (198)	79.7 (32, 99)	79.4 (12.2)
Quiz score (220)	1 (0, 4)	1.4 (1.1)

Table 1 presents the summary statistics. This sample is over-represented by female (80.4 per cent) and employed (72.1 per cent excluding 'not working' and 'never worked') students, which should be noted as a limitation of the research. Each participant was assigned an Australian Tertiary Admission Rank (ATAR) to enable comparison of university entry scores across states. The ATARs of this sample range from 32 to 99, with an average of 79.4 and standard deviation of 12.2.

C Results

This section of the paper reports the results of the specific tax literacy questions that were posed in relation to the sample aged 20 years of age or less as summarised in Table 1 above. Comparisons of the results against the previous adult tax literacy survey by Chardon will also be made where relevant.⁴³ The survey also provided participants with an opportunity to add any relevant comments about their financial skills education. A thematic analysis of the responses to that question will also be presented at the end of this section.

In relation to participants self-rating of their tax knowledge, more than half of the students rated themselves low (38.2 per cent) or very low (25.8 per cent) in terms of tax knowledge. Although the previous tax literacy research by Chardon explored participants' self-rated 'confidence' as opposed to 'understanding', the results here are broadly consistent, in that participants appear to self-rate both their confidence and understanding of taxation concepts as much lower than they were for financial concepts such as budgeting and saving.⁴⁴ Interestingly, the current survey found that financial concepts such as superannuation and retirement planning also have a low level of self-rated understanding. A finding of low self-rated understanding might be expected for those areas which will be more relevant later in life, but the same cannot be said for taxation concepts, which would be relevant earlier in life -- particularly given that the current sample is over-represented by those currently in paid employment.

In relation to specific tax knowledge questions, the first question was presented as follows:

As far as you are aware, is superannuation generally taxed at a lower, higher or the same rate as other investments?

As seen in Table 1, 36.9 per cent of participants answered correctly that superannuation was taxed at a lower rate than other investments. The most common alternative response was 'Do not know'. In comparing the results of this question against the adult tax literacy survey by Chardon, where 57.3 per cent of adults scored correctly for the same question, it appears that those under 20 years of age have less understanding of the taxation of superannuation.⁴⁵

⁴³ Chardon, above n 5.

⁴⁴ Ibid.

⁴⁵ Chardon, above n 5.

The second tax knowledge question was in relation to the calculation of assessable income, and therefore an understanding of the difference between assessable income and taxable income. The question was posed as follows:

If a person has total employment income of \$70,000, interest from a bank account of \$100, gross income from a rental property of \$16,000, \$4,000 in deductible salary expenses, and deductions (including interest) relating to their rental property of \$14,000, what is their total assessable income? (Please use a calculator if preferred)

The correct response was \$86,100 (ie the gross assessable amount excluding deductions). As seen in Table 1, only 20 per cent of participants scored correctly for this question. The most common alternative response was 'Do not know'. This demonstrates that the concept of assessable income and/or the difference between assessable income and taxable income is not well understood by university students aged 20 years and under. The adult tax literacy survey by Chardon, found 53.1 per cent of adults scored correctly. Again, those under 20 years of age appear to have much lower understanding in relation to assessable income.⁴⁶

The third tax knowledge question explored participant's ability to calculate tax payable, given a taxable income figure and a current version of the tax tables. The question was presented as follows:

If a person's total taxable income for the 2014/2015 tax year was \$40,000, what is their total tax payable for the year (excluding medicare levy)? Use the following personal tax rates (please use a calculator if preferred)

Taxable income	Tax on this income
0 – \$18,200	NIL
\$18,201 – \$37,000	19c for each \$1 over \$18,200
\$37,001 – \$80,000	\$3,572 plus 32.5c for each \$1 over \$37,000
\$80,001 – \$180,000	\$17,547 plus 37c for each \$1 over \$80,000
\$180,001 and over	\$54,547 plus 45c for each \$1 over \$180,000

The correct answer was therefore \$4,547. The results were that 56.8 per cent of participants chose the correct answer. The most common alternate response was 'Do not know'. Previous tax literacy research found a much higher correct response rate to the same question among adults (71.5 per cent).⁴⁷

The final tax knowledge question asked about participant's understanding of negative gearing. The question was presented as follows:

A negatively geared investment means (select all that apply)

- *The investment is likely to decrease in value over time*

⁴⁶ Chardon, above n 42.

⁴⁷ Chardon, above n 5.

- *The interest on the loan is less than the income received from the investment*
- *There are no borrowings associated with the investment*
- *The interest on the loan is greater than the income received from the investment*
- *Negative gearing means something else*
- *Do not know*
- *Prefer not to answer*

The correct option to choose here was 'The interest on the loan is greater than the income received from the investment'. Only 17.5 per cent of participants selected the correct response. The most common alternative responses were 'Do not know' followed by 'The investment is likely to decrease in value over time'. The adult tax literacy survey found 54.1 per cent of adults selected the correct response, again signalling potentially much lower understanding in younger persons.

D Self-rated Understanding Compared With Actual Understanding

A total tax quiz score was computed for each participant as the number of correct answers to the four tax questions. Table 1 (above) shows that nearly 85 per cent of the students could not correctly answer more than two out of the four tax questions.

As illustrated in the clustered bar chart in Figure 1;, the sample groups of higher self-ratings tend to have higher quiz scores. Prior to answering the knowledge questions in the survey, participants were asked to rate their understanding of a range of concepts from 'Very Low' through to 'Very High'. Figure 1 shows a clustered bar chart of the self-ratings grouped by the total tax quiz score (0 – 4 questions correct), which allows a visual comparison of their self-rated and actual performance in tax literacy. As can be seen in Figure 1, a large number of participants who self-rated as either 'Very Low' or 'Low', scored either 1 or 0 correct for the tax knowledge questions. The two evaluations demonstrate a moderately positive correlation (Spearman's rank correlation coefficient = 0.325, $p < 0.001$).

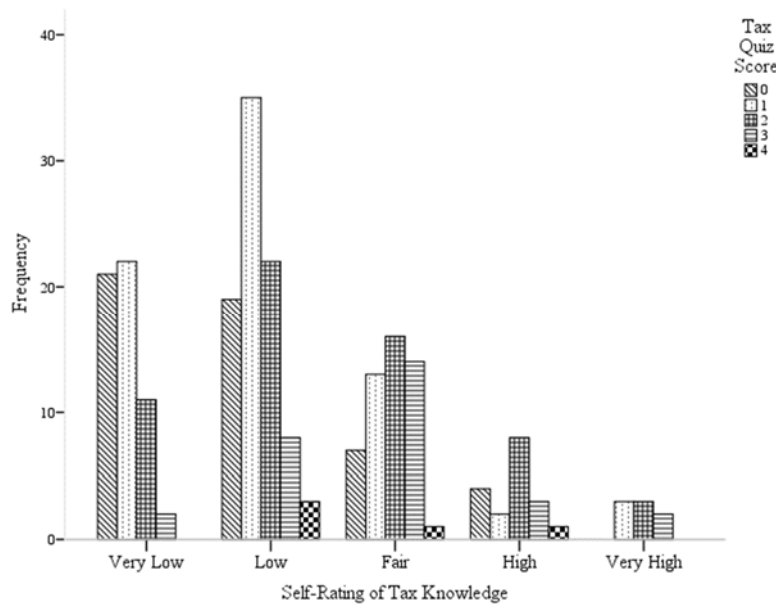


Figure 1: Clustered bar chart of tax quiz score distribution by self-rating level

Table 2 compares the distribution and the average of the individual tax quiz scores across self-rating levels. Chi-square test for linearity ($\chi^2(1) = 20.096, p < .001$) confirmed the linear association between the two ordinal scales. One-way ANOVA result ($F(4, 215) = 6.48, p < .001$) confirmed the differences in the average of tax quiz score between self-rating levels. All these support the claim of directional consistency between self-rating and question score. This result is consistent with previous research by Chardon, which found less over-confidence in relation to tax and superannuation issues broadly.⁴⁸ Though over-confidence tends to be high in financial literacy research generally,⁴⁹ it appears this is not necessarily the case for taxation concepts.

Table 2: Tax Quiz Score Distribution by self-rating levels (N=220)

Self-rating (n)	Average quiz score (%)					Quiz score Mean (SD)
	0	1	2	3	4	
Very low (56)	37.5	39.3	19.6	3.6	0.0	0.9 (0.8)
Low (87)	21.8	40.2	25.3	9.2	3.4	1.3 (1.0)
Fair (51)	13.7	25.5	31.4	27.5	2.0	1.8 (1.1)
High (18)	22.2	11.1	44.4	16.7	5.6	1.7 (1.2)
Very high (8)	0.0	37.5	37.5	25.0	0.0	1.9 (0.8)

⁴⁸ Ibid.

⁴⁹ Bateman et al, above n 40; Natalie Gallery et al, 'Financial Literacy and Pension Investment Decisions' (2011) 27(3) *Financial Accountability & Management* 286.

E Predictors of Self-Rated Understanding, Overall Tax Score and Individual Questions

To predict self-rated understanding and actual understanding respectively, an ordinal logistic regression model was estimated for each ordinal response variable using such predictors as gender (with females as reference), employment (with the employed as reference), and ATAR (see Table 3 below). Both models are overall statistically significant at the 5 per cent level and both meet the parallel line assumption for ordinal regressions. Both models also show acceptable goodness of fit, although the fit of self-rating model is marginally significant due to the small category of 'very high'.⁵⁰

Gender and employment were found to be statistically significant predictors of self-rated understanding of tax knowledge, while ATAR was not (see Table 3).

Table 3: Results of ordinal logistic regressions of self-rating and quiz score and binary logistic regressions of questions (N=165)

Predictor	Response					
	Self-rating	Overall Tax Score	Q1 Tax and Super	Q2 Assessable Income	Q3 Tax Payable	Q4 Negative Gearing
Male	0.816**	0.831**	1.367***	0.177	0.320	0.356
Unemployed	-0.817**	-0.080	-1.093**	-0.068	0.259	0.445
ATAR	0.012	0.020*	0.016	0.014	0.015	0.014
Model fit						
Likelihood ratio test of omnibus significance X ² (d.f.)	10.1(3)**	8.8(3)**	15.3(3)**	.819(3)	2.594(3)	3.055(3)
Parallel lines test X ² (d.f.)	3.6(9)	9.3(9)	NA	NA	NA	NA
Pearson goodness of fit test X ² (d.f.)	509.2(469)*	470.0(469)	114.5(115)	127.2(115)	130.4(115)	121.5(115)
Pseudo R ² (Nagelkerke)	.064	.055	.121	.008	.021	.028

*** Statistically significant at 1% level; ** at 5% level; * at 10% level

The positive coefficient for 'male' means that male students tend to rate themselves higher than females for any rating level. The ratio of the odds for lower to higher self-ratings between males and females is $0.44 = \exp(-\beta) = \exp(-0.816)$, holding all

⁵⁰ J. Scott Long, *Regression Models for Categorical and Limited Dependent Variables* (Sage Publications, 1st ed, 1997).

other variables constant. The unemployed students tend to rate themselves lower than the employed. The ratio of the odds for lower to higher self-ratings between the unemployed and the employed is 2.26, all else being equal.

For overall tax score, gender and ATAR were statistically significant predictors, whereas employment was not (see Table 3). Male students score higher in the tax quizzes than females. The odds for lower to higher quiz scores among males is 0.44 times (or 56 per cent) smaller than the odds among females, holding all other variables constant. Students with higher ATAR also tend to score slightly higher in the tax quizzes. For one unit increase in ATAR, the odds for lower to higher quiz scores decreases by a factor of 0.98 (or 2 per cent), holding all other variables constant. This finding is consistent with the earlier findings in relation to adult tax literacy, which found that gender and education level were significantly correlated with tax literacy score.⁵¹ However, previously it has been found that employment hours was strongly correlated with tax literacy score.⁵²

A binary logistic regression model was estimated to predict each tax question score using gender, employment, and ATAR. Considering the similar overall findings in the four tax questions, the errors terms of the logit functions might be substantially positively correlated. A multivariate probit model was estimated using State13.⁵³ Only the model for Question 1 (taxation of superannuation) is overall statically significant, which means that none of the three predictors affects Question 2, 3, or 4. For Question 1 (taxation of superannuation), male and employed students have a higher chance of giving the correct answer. The odds of correctly answering Question 1 among males is nearly four times larger than the odds among females, all else being equal. Among employed students, the odds of correctly answering Question 1 is almost three times larger than the odds among the unemployed, all else being equal. This finding in relation to males and the employed is consistent with the adult tax literacy survey, which found a relationship between high tax literacy scores and gender as well as employment hours.⁵⁴

F Qualitative Analysis

Participants were able to make further comments about their 'financial skills education' at the end of the survey. A thematic analysis of the responses in this section was also undertaken.⁵⁵ The most common theme was that participants identified family and/or parents as their primary source of financial knowledge to date. This is highlighted by the following comments:

⁵¹ Chardon, above n 42.

⁵² Ibid.

⁵³ The results were that no pair of error terms was substantially correlated (all correlation were less than 0.40). Therefore, the authors decided to interpret the results of four separate binary logistic regressions (see Table 3). Lorenzo Cappellari and Stephen P. Jenkins, 'Multivariate probit regression using simulated maximum likelihood' (2003) 3(3) *The Stata Journal* 278.

⁵⁴ Chardon, above n 42.

⁵⁵ Michael Huberman and Matthew B. Miles, *The Qualitative Researcher's Companion* (SAGE Publications, 2002).

‘All I’ve learnt has been from my parents and even then I still don’t know how to file tax returns or check my super or invest anything.’

‘Never really had any at school. I didn’t even know how to do my taxes. I had to have my mother help me the first couple of times.’

‘Virtually none, other than my parents.’

This theme highlights one of the common problems of the financial literacy context. In the past, financial literacy education programs within schools were scarce. Therefore, this important financial decision making knowledge tended to come from families or close friends. Since previous surveys of adult financial and tax literacy have found significant deficiencies in financial and tax knowledge and behaviour in the adult population,⁵⁶ it is argued that misunderstandings are therefore passed on to the younger generation unless there is intervention.

Another common theme was that participants recognised the importance of financial education. The following comments highlight that within this broad theme, tax and superannuation knowledge were recognised as important aspects.

‘But I have no recollections of learning anything about tax, superannuation or any of that other stuff. I like to think I am intelligent, but in this area I know nothing.’

‘I believe all kids should be thought (sic) how to budget pay bills and other important life/financial skills esp (sic) super/tax and savings.’

Further, the survey found that 61.6 per cent of participants ‘would prefer to learn more financial skills in university’.

Overall, the results demonstrate that there is relatively low understanding of tax and superannuation concepts among the university students surveyed. This low level of knowledge was also reflected in low levels of self-rated understanding. Gender and employment were found to be indicators of increased tax and superannuation knowledge. The qualitative analysis also suggested the importance of tax and superannuation knowledge.

IV IMPLICATIONS AND OPPORTUNITIES FOR UNIVERSITY TEACHING

The results presented in this article add to the growing evidence that basic tax and superannuation concepts are an important aspect to be included in any financial literacy or capability framework. Previous research by Chardon, Cull and Whitton has demonstrated that there may be low levels of understanding of some important basic tax and superannuation concepts.⁵⁷ The results presented in this paper support these previous findings and further find that understandings of basic tax and superannuation concepts are generally lower in those under the age of 20 years.

⁵⁶ ANZ, *Adult Financial Literacy in Australia – Full Report of the results from the 2011 ANZ Survey*, above n 4; Chardon, above n 5.

⁵⁷ Chardon, above n 5; Cull and Whitton, above n 29.

The results also demonstrate a correlation between gender, ATAR and tax knowledge outcomes.

Given the literature presented in relation to the importance of continued financial education throughout school and university, the prevalence of financial education programs in the United States and the arguments that high levels of debt and low levels of financial literacy in university students is indicative of a risk of poor financial outcomes, it is argued that the teaching of financial literacy (including tax aspects) at university should be considered as a priority. The qualitative data drawn from the survey further supports this argument.

The results also provide some important insights for tax teaching and advisor training more broadly. It is submitted that the specific evidence presented in this paper and previous financial literacy evidence should be used in the design of any program that prepares accounting, legal or tax advisors for practice. Tax compliance research has suggested that complexity of tax concepts may cause misunderstandings between a taxpayer and their tax agent.⁵⁸ This finding in the empirical research -- that there are broad misunderstandings in relation to basic aspects of taxation policy -- is important, and should be taught in taxation law courses to enable potential advisors (whether accountants, lawyers or financial advisors) to mitigate misunderstandings. Advisors need to be acutely aware of the level of financial, tax and superannuation knowledge their clients will have, which demographics are most likely to have poor levels of financial literacy (females and those with lower education levels) and strategies to explain these concepts most effectively. Understanding the levels of financial and tax literacy of clients and demographic groups will aid in ensuring our students are equipped with the knowledge they need to communicate effectively with their clients.

Enthusiastic and committed discipline leaders are key to driving the inclusion of financial education programs at the university level, whether that be stand-alone cross-disciplinary courses or embedded units in other courses.⁵⁹ As Crain argues, 'the foundations of financial knowledge and skills should be introduced in elementary schools, expanded in high schools and reinforced in colleges'.⁶⁰ In the context of competing demands from university program reviews, other disciplines and professional bodies, it is important for university academics (specifically tax teachers) to remain committed to and passionate about the importance of tax education in university programs. The evidence that there are low levels of tax literacy in the younger generation and that it is seen by them as important and worthwhile, only serves to bolster the argument for the inclusion of tax literacy education programs within schools and universities.

The continued passion for tax teaching from discipline leaders and championing of cross-disciplinary teaching opportunities serve a number of important purposes. It impacts upon national policy by furthering the National Financial Literacy Strategy

⁵⁸ Margaret McKerchar, *The Impact of Complexity upon Unintentional Non-Compliance for Australian Personal Income Taxpayers* (PhD Thesis, UNSW, 2002).

⁵⁹ Crain, above n 34.

⁶⁰ Ibid 14.

as well as creating better tax advisors and more tax-literate consumers who are able to make more informed contributions to tax policy into the future.

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EMERGENCE, GROWTH AND MOBILITY OF EUROPEAN COMPETENCE ON DIRECT TAX REGIME: AN ANALYTICAL AND EVOLUTIONARY REVIEW

SHAFI U KHAN NIAZI*

ABSTRACT

Since its founding days, the European Union (EU) constitution has not explicitly empowered the Union to formulate policy in the field of direct taxes; this area has been broadly left to the Member States. To date, limited EU-level intervention in direct taxes can, in part, be attributed to this power-allocation scheme in the European constitution. In fact, more than three decades since the inception of the EU, no substantive European legislation has existed in this area. Nevertheless, the EU was, and still is, implicitly empowered to enact tax laws if tax policies of Member States infringe the EU's single-market principles. This article analyses the EU's direct tax powers, reviews the EU (tax) competence 'submerged' in the constitutional freedoms and single-market idea and its sub-textual growth, and the way this progressively emerged. It also argues that as the single market grows, so do the possible meanings of EU competence in policy areas affecting that market, including (implicit) tax powers. By analysing growth and mobility in the (tax) legislative regime, the article concludes that the policy of limited EU intervention in the realm of direct taxes may not persist in the long run, but rather may shift to expansive legislation in times ahead.

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I INTRODUCTION

The European Union (EU) is a single market of 28 Member States.¹ To achieve its single-market objective, the EU adopted several legislative measures including single customs tariffs for the region, and intervened closely to harmonise national VAT regimes. To date, however, little progress has been made to integrate Members' income and corporate tax regimes. This article reviews this situation and offers a legal analysis of the lack of wider EU-level actions to integrate direct taxes of Member States. Based on the evolution of the division of powers between states and the supranational polity, the EU, this article argues that the current situation of limited intervention in the field of direct taxes may not persist in the long run, but might shift to wide-ranging EU-level actions in the times ahead.

Essentially, the EU direct tax law² foresees the institution of an internal European market.³ The governing treaties – the 'constitutional' document of the jurisdiction –⁴ proclaim direct taxes generally as Members' terrain,⁵ if they do not violate

¹ The EU comprises 28 Member States. The United Kingdom decided to leave the Union in a referendum held on 23 June 2016. However, until the UK formally departs, the Union membership remains 28.

² Direct taxation in this article refers to income taxes (personal and corporate taxes), notwithstanding any other forms of direct taxes in the national jurisdictions of Member States.

³ Creation of an internal market within the EU jurisdiction is a constitutional obligation under the EU law; see, eg, the Treaty on European Union (TEU) below n 4, art 3, [2010] OJ C 83/1, 17 and Treaty on the Functioning of the European Union (TFEU), below n 4, art 26, [2010] OJ C 83/1, 59. For the text of the internal market clause, see below n 18. References to single, common or Union market in this article will effectively mean internal market.

⁴ EU constitution or governing treaties in this article refers to respective treaty document in force in EU. The article refers to several EU treaties: (1) the existing constitution known as Lisbon Treaty became effective from 1 December 2009. It comprises: *The Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union*, [2010] OJ C 83/1 (respectively *TEU* and *TFEU*). The predecessors of the Lisbon Treaty were: (2) *The Consolidated Versions of the Treaty on European Union and the Treaty Establishing the European Community*, [2006] OJ C 321 E/1 (respectively *TEU pre-Lisbon* and *EC Treaty*); (3) *Treaty of Nice amending the Treaty on the European Union, the Treaty Establishing the European Communities and Certain Related Acts*, [2001] OJ C/80/1 (respectively, *TEU (Nice version)* and *EC Treaty (Nice version)*); (4) *Treaty of Amsterdam amending the Treaty on the European Union, the Treaties Establishing the European Communities and Certain Related Acts*, [1997] OJ C 340/1 (*Amsterdam Treaty*); (5) *Treaty on European Union Together with the Complete Text of Treaty Establishing the European Community* (until Maastricht), [1992] OJ C 224/1 [hereinafter *Maastricht EC Treaty*]; (6) *Single European Act*, [1987] OJ L 169/1 (*SEA*); (7) *Treaty Establishing the European Economic Community*, 25 March 1957, 298 UNTS 11 (*EEC Treaty*).

⁵ Broadly, the constitution assigns powers in the direct tax regime to Members. For example, in the existing constitution, areas of exclusive Union competences as well as areas of competences shared by both EU and Members (TFEU, above n 4, arts 3, 4(2), [2010] OJ C 83/1, 51–52) do not confer tax powers to EU in express form. Hence, pursuant to principle of conferral of residual powers (TEU, above n 4, art 4(1), [2010] OJ C 83/1, 18) that states powers not conferred upon the Union to stay (subject to TFEU, above n 4, art 4(1), [2010] OJ C 83/1, 51) with Members, direct taxation generally remains a Members' domain. Legal scholarship on EU tax law also holds similar views; see, eg, Charles E McLure, Jr, 'Legislative,

fundamental freedoms⁶ and prohibition principles⁷ (collectively called ‘freedom clauses’) enshrined in the constitution to institute a single market. The national governments of Member States are thus empowered to formulate their own domestic tax policies, as long as these policies do not infringe the EU law. On the other hand, it is obviously hard to achieve harmony in 28 sovereign and parallel tax systems operative in a single European market. Subject to specified principles,⁸ the EU nevertheless always had – and still has – the power to enact tax legislation⁹ that could intervene in those national tax policies which impede the functioning of a single economic market. These are unspoken powers in the EU constitution and, as this article canvasses, they remain buried in the legal subtext and are likely to expand further over time.

Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the US and the EU’ (2008) 14 *Columbia Journal of European Law* 377, 382 (observing that ‘[M]ember States of the EC retain competence in the tax field, except insofar as exercise of the competence is restricted by regulations or directives’). McLure further says that it is well established in the case law that ‘Member States must none the less exercise that competence consistently with Community law’ (citing *Marks & Spencer v Halsey* (C-446/03) [2005] ECR I-10837, para 29, and citations to previous cases provided there).

⁶ Freedoms guaranteed (referred to as fundamental freedoms) in the internal market having nexus to direct taxation are: freedom of movement to work (TFEU, above n 4, art 45), freedom to right of establishment (TFEU, above n 4, art 49), freedom to provide services (TFEU, above n 4, art 56), freedom of movement of capital and payments (TFEU, above n 4, art 63).

⁷ Prohibitions declared in the internal market having nexus to direct taxation are: prohibition on discrimination on the basis of nationality (TFEU, above n 4, art 18) and prohibition on state aid (TFEU, above n 4, art 107).

⁸ For intervening national policies on direct taxes, the supranational powers are exercised and governed by schematic legal orders set out in the EU law, in particular provisions meant for division of powers (below n 17) and principles of subsidiarity and proportionality (see below Part III(C)).

⁹ There are several ways to intervene in national tax policies. The most well known is through the adoption of directives, one of the forms of EU legislative acts. The current legislation on direct taxes (see below Part II(C)) takes the form of directives, which are binding under the EU law. However, directives have only vertical effect (enforcement of EU rights against state); they lack (horizontal) enforcement of EU rights against private persons. The doctrine of direct effect originates from the European Court of Justice ruling in the landmark case *Van Gend en Loos v Netherlandse Administratie der Belastingen* (26/62) [1963] ECR 1. This ruling stipulates that certain provisions (or instruments) of EU law inherit legal force that by virtue of direct effect are effective in Member States without being enacted into domestic laws. For more details on this principle, see, eg, Karen Davies, *Understand European Union Law* (5th ed, Ebooks Corporation, 2013) 69–84. On evolution and development of this principle, see Bruno de Witte, ‘Direct Effect, Primacy, and the Nature of Legal Order’ in Paul Craig and G de Burca (eds) *The Evolution of EU Law* (Oxford University Press, 2nd ed, 2011) 323.

Besides directive-based legislation, the EU is also empowered to intervene in those national tax policies which are selective in nature and can distort free competition in the single market. For these powers, see TFEU, above n 4, arts 107–109; on use of these powers by the European Commission in recent times, see, eg, <http://europa.eu/rapid/press-release_IP-16-2923_en.htm> (last accessed 30 August 2016), on Irish tax rulings issued to Apple Ireland.

Unlike VAT, which is subject to relatively strict central control by means of a VAT Directive¹⁰ based on explicit constitutional provisions,¹¹ the legislative measures adopted to date in the field of direct taxes are narrow in scope, dealing with discreet issues.¹² In fact, the EU-level legislation on direct taxes is constrained by two key factors: First, a constitutional framework that, in stark contrast with, for example, customs tariffs, contains no express provision directing the EU to intervene into the field of direct taxes. The Members, therefore, generally retain autonomy in this policy area.¹³ The second is the fact that the EU tax legislation requires unanimous consensus of all Members,¹⁴ a task difficult to achieve in the wake of fiscal sovereignty claims of national treasuries. With no change foreseeable in the unanimity rule to adopt direct tax legislation, any dramatic shift in politics of taxation in the near future is not expected. Nevertheless, the EU may be entering a new evolutionary phase of an ‘ever closer union’¹⁵ that could change the dynamics of the balance of powers between Member States and the EU, and this merits closer examination. This article examines the first of the two key restrictions posed to the tax legislation under EU law – that is, lack of express constitutional powers to enact measures in the field of direct taxes.

Investigation of the legislative regimes and balance of powers in the EU law is a challenging task. First, it involves scrutiny of a unique constitutional framework that is ‘a blend of international law, national constitutional law, and federalism’.¹⁶ Second, the analysis involves a legislative regime that is not otherwise articulated in the EU constitution – for that is the case with direct taxes. Thus, the complexity associated with defining four corners of a Union action in this area within a ‘sub-textual’ constitutional framework of division of powers¹⁷ is substantial. This article explores the gradual

¹⁰ *Council Directive 2006/112/EC on the Common System of Value Added Tax*, [2006] OJ L 347/1 (here referred to as the Existing VAT Directive). It replaced the earlier VAT legislation based on *Council Directive 77/388/EEC on Harmonization of the Laws of the Member States relating to Turnover Taxes – Common System of Value Added Tax: Uniform Basis of Assessment*, [1977] OJ L 145/1 (here referred to as the Old VAT Directive).

¹¹ See below Part III(B)(2).

¹² Each Directive adopted on direct taxes is fairly limited in scope and deals with specified issue; see, eg, below Part II(C).

¹³ See above n 5.

¹⁴ For direct taxation, existing legislative instruments (Directives) are based on TFEU, above n 4, art 115, which requires the unanimous consensus of all Members (each represented by respective minister in the Council of the EU). The unanimity criterion on tax legislation is popularly known as veto power of each Member; see, eg, Michael J Graetz and Alvin C Warren, Jr, ‘Income Tax Discrimination and the Political and Economic Integration of Europe’ (2006) 115 *Yale Law Journal* 1190–1191 (stating that the Council cannot act on income tax issues without unanimous consensus as any Member can veto any proposal).

¹⁵ A commitment of Member States ‘to create an ever closer union among the people of the Europe’ was inserted in the preamble under the Maastricht Treaty ([1992] OJ C 224/1, 3), and continues to exist there in the current EU law.

¹⁶ Graetz and Warren, above n 14, 1190 (citing James A Caporaso, ‘The European Union and Forms of State: Westphalian, Regulatory or Post-Modern?’ (1996) 34 *Journal of Common Market Studies* 29).

¹⁷ For the constitutional plan on division of powers between EU and Members, see principle of conferral of competences (TEU, above n 4, arts 4, 5(1) (2)), general scope of exercising competences (TFEU, above n 4, art 2), EU exclusive competences (TFEU, above n 4, art 3), EU-Members shared competences (TFEU, above n 4, art 4), ensuring coordination (TFEU, above n 4, art 5), EU supporting actions (TFEU, above n 4, art 6), Protocol No. 25 (on exercise of shared competences, [2010] OJ C 83/1, 307); Declaration No. 18 annexed to the Treaty of

emergence of European tax power, the way it developed over time, and its possible expansion in prospect.

The remainder of the article is structured as follows. Part II provides insights into the implied character of EU powers to legislate direct tax measures in accordance with the constitutional scheme. It also offers a concise appraisal of existing EU legislation in the field of direct taxes. Part III analyses factors embedded in the EU legal system that have potential to impact Union-level actions in this policy area. It explores the way the three factors – (a) the implied character, (b) the general legal basis, and (c) the subsidiarity rule – could possibly impact EU tax legislation. Part IV offers a historical discourse, tracks the tax journey and overviews the way EU tax powers have evolved since the founding days to attain constitutional force. By reviewing developments since inception of the EU, it also examines the so-called *inertia* of direct tax legislation during the initial three decades alongside the sub-textual legislative power in tax matters that existed *submerged* in the constitution under the single market principles. It then examines the gradual emergence and growth of European powers in the area of direct taxes. This part also argues that the persistent growth in interstate trade and transnational economic activity attained over time through freedoms induce corresponding changes in the integrational status of the single market. Accordingly, EU tax competence, now gestating in the undergrowth of freedom clauses, attains new meanings with the passage of time and gradually keeps expanding. The article also briefly touches upon the most recent EU developments on tax practices that are detrimental to the single market – those that resulted in the widely publicised taxation of Apple in Ireland. Finally, Part V draws a brief conclusion.

II SOURCES OF EU POWERS TO LEGISLATE MEASURES FOR DIRECT TAX INTEGRATION

The EU law is silent on legislative powers relating to income tax policymaking, as that realm has generally been left to the Members. The EU-level legislative powers are derived indirectly from other sources embedded in the constitution. To trace an implicit seamless story of direct tax law, three constitutional commitments together serve as threads (prerequisites) to interweave as the broad contours of EU tax powers: (1) a constitutional obligation to constitute a single market¹⁸ in accordance with the freedom clauses;¹⁹ (2) a constitutional authority or legal basis to enact measures to remove disparities in national tax rules and integrate them to make them compatible with the

Lisbon (principles of de-conferral of shared competence, [2010] OJ C 83/1, 344–45), etc. On constitutional principles setting out the plan to govern the use of non-exclusive EU competences, see principles of subsidiarity and proportionality (TEU, above n 4, art 5(3), (4), and below Part III(C)).

¹⁸ On specific obligations assigned to the Union, see TEU, above n 4, art 3(3): ‘The Union shall establish an internal market’, and corresponding powers vested in the Union, in particular, under TFEU, above n 4, art 26: ‘1. The Union shall adopt measures with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relevant provisions of the Treaties. 2. The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.’

¹⁹ See above nn 6–7. *Freedom clauses* serve as prime vehicles to achieve the core objective of creating single market.

single market notion;²⁰ and (3) while adopting such measures, a requirement that Union action remain consistent with power allocation scheme and the regulatory clauses set out in the constitution.²¹ The result is that a potential EU action in taxation is bound to adhere to these constitutional contemplations. Of these three ingredients, the first two are the main sources of power allocation that respectively inherit legal authority for supranational EU actions. The third component does not itself confer competence, but is rather an overseeing and regulatory provision, as explained in Part III(C).

A The Powers Inherent in Single Market Principles

Since its inception in 1957 through the foundational treaty establishing the European Economic Community (EEC Treaty), the EU law has not expressly mentioned direct taxes. The only explicit reference – concerning Members’ obligation to eliminate double taxation –²² also no longer exists, since the Treaty of Lisbon came into force. Despite lack of any directions and absence of its explicit mention in the body of the primary law,²³ EU tax competence remained – and still remains – integral to the *multilayered* EU constitution.²⁴ The obligation to institute a single European market together with freedom clauses²⁵ creates room for an EU role in the field of direct taxes.

As long as national jurisdictions of Member States do not infringe the EU law in terms of having tax rules reasonably compatible with the freedom clauses and the single market notion, hypothetically, there would arise hardly any need to legislate EU-wide income tax rules. In practice, however, it is conceivable that several situations triggered by parallel exercise of multiple sovereign tax policies might inevitably end up in derogation to the freedom clauses. Then, where national tax measures intersect with the freedom clauses and infringe upon them, Union-wide measures might be necessary. Owing largely to the dual constraints posed to supranational tax legislation pointed out in Part I, such efforts have not, to date, translated into substantive legislation. In past, several legislative

²⁰ These provisions embody those tools which are destined to provide a precise (legal) base, and serve as a launching pad for legislative acts. Consequently, to initiate legislation in different areas, there are several constitutional platforms (bases); see, eg, below n 27.

²¹ A legislative action of the Union in the area of direct taxes, while fulfilling its obligations to institute a single market, is akin to intervention in a policy area that otherwise is generally a Members’ domain. This makes the division of powers equilibrium between Members and Union convoluted. In any case, the equilibrium has to be in compliance with subsidiarity and proportionality rules (see below Part III(C)) that govern the legislative acts on all areas of non-exclusive EU competences including direct taxes.

²² See EC Treaty, above n 4, art 293, second indent, [2006] OJ C 321 E/1, 173; for legal text, see below n 121.

²³ Primary law, in EU parlance, refers to governing treaties or the constitution, whereas secondary law refers to legislation enacted thereunder, such as Regulations, Directives, Decisions, etc.

²⁴ The expression *multilayered* highlights specific design of EU law that comprises a unique mix of national and international laws; see, eg, Michael Longo *Constitutionalising Europe: Processes and Practices* (Ashgate, 2006) 11 (observing that ‘The EU has been described as a multi-level governance; a postmodern polity; a confederation; a quasi-federal system featuring pre-federal institutions; a sui generis legal order’ and so on); see also above n 16 and accompanying text.

²⁵ For constitutional authority on freedom clauses, see above nn 6–7.

proposals in this policy area either could not take the form of a binding law or remain awaiting approval due to lack of unanimous consensus of Member States.²⁶

B An Implicit Legal Basis to Remove Disparities

The initiation of an EU-level action requires a legal basis. That legal platform serves as a constitutional vehicle to translate the intents (legislative agenda) into actions (enactments). The clause that serves as a potential legal platform from which to initiate an EU-level (tax) measure is a general constitutional provision akin to the constitutional powers vested in freedom clauses to intervene into national (tax) rules in case the latter violate the single market notion. Article 115 (TFEU) authorises the EU to integrate those national laws (including direct taxes) that are incidental to the establishment or functioning of the single market.

The authority crafted in this legal basis inherits multiple characteristics that would support the initiation of a measure to integrate Member policy areas (including taxes). First, it is a constitutional prerequisite to initiating a legislative act.²⁷ Second, it determines voting criteria to enact legislation – that is, whether majority or unanimity of Members is required – that in turn has its own implications.²⁸ Third, among multiple legislative forms (such as regulation, directive, or decision), the legal basis in question sets out to adopt a directive form to enact direct tax legislation.²⁹ A directive is a form of binding legislation that allows Members liberty to choose their own modes of transposition into national rules to achieve its objectives. In this way, the legal platform has affinities with the state–suprastate power-sharing formula envisioned under the EU legal system. Furthermore, on a case-to-case basis, the chosen legal tools may also be

²⁶ Some of the legislative initiatives pursuant to eliminating specified disparities and bringing integration in direct taxes ended successfully in adoption of Directives (see below Part II(C)); while others are either pending, eg, European Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4 – 2011/0058 (CNS) (March 2011) (*Commission Proposal on CCCTB Directive*), or withdrawn (eg European Commission Proposals, below n 97).

²⁷ ‘Legal acts shall state the reasons on which they are based’ (TFEU, above n 4, art 296, para 2). On various legal bases for legislative actions in different policy sectors, see, eg, TFEU, above n 4, arts 14, 16, 18–21, 22–25, 33, 43, 46, 48, 50–53, 56, 59, 64, 65, 75, 77–79, 81, 82–89, 91, 95, 103, 109, 113–116, 118, 352 and so forth. A few legal bases are general in character and may serve to initiate legislation in multiple sectors; eg, TFEU, above n 4, art 115 (see below Part III(B)(1)) and art 352.

²⁸ The unanimity criterion or veto power held by each Member is widely considered as one of the leading factors impeding legislation on direct taxes; see, eg, Tracy A Kaye, ‘Direct Taxation in the European Union: From Maastricht to Lisbon’ (2012) 35 *Fordham International Law Journal* 1232 (observing that unlike various other sectors having a requirement of qualified majority legislative procedure, direct tax harmonisation proceeded slowly due to the need for unanimous legislative process).

²⁹ Legislative acts in the form of Regulation, Directive, and Decision are binding, and those in the form of Recommendation and Opinion are non-binding. While both Regulation and Decision are binding in their entirety, and therefore of direct effect, the former is generally applicable to all Members, unlike the latter, which applies to whom it specifies. In comparison, directive is a type of legislation applicable to whom addressed but lacks the horizontal direct effect (rights enforceable only against state and not private parties). The Members are free to choose form and modalities to integrate it into their national laws with an obligation to the effect that the results desired by it must be achieved (see TFEU, above n 4, art 288; on principle of direct effect, see above n 9).

indicative of the schema of other broader guidelines – relevant but scattered elsewhere in the EU constitution – on exercise of powers in the multilayered European law.³⁰

C Exercise of Implicit Powers Until Now

The EU has exercised very limited legislative powers in the area of direct taxes. The legislation adopted to date is limited to a few narrow and discrete measures focusing predominantly on qualifying corporate taxpayers. The legislative instruments tend to limit double taxation by targeting the tax consequences of itemised cross-border transactions of specified taxpayers. In addition to assistance and recovery measures,³¹ a few such instruments (directives) have been issued to date by the legislator (the Council of EU, where each Member State is represented by its respective Minister) on the recommendations of the executive organ (the European Commission).³² The legislation in force generally aims to abolish specified forms of double tax burdens likely to arise pursuant to divergent national tax systems in the internal market. A brief description of each directive follows.

*The Parent–Subsidiary Directive*³³ is meant to bring interstate and intrastate companies to parity by removing tax disadvantages to the former. The legislation mitigates economic double taxation between parent and subsidiary by stipulating that the Member State of a parent company should either exempt the dividend distribution or extend an indirect credit of tax payments by the subsidiary. The Directive prohibits the Member State of a subsidiary company compulsorily imposing withholding tax on the dividend to avoid juridical double taxation. The scope of this directive is dividend-specific and limited to related companies, and is further subject to a qualifying ‘minimum holding’ requirement.

The Mergers Directive,³⁴ at the time of merger, division, partial division or transfer of assets, prohibits the state of the transferring company to tax any built-in capital gain. The taxation of capital gain is not removed altogether; rather, it is deferred. If taxation of the gain were not deferred, the transferring Member State would tax the difference between the book value and current value at the time of transfer, and the new state of residence

³⁰ See, eg, *Council Directive 2010/24/EU concerning Mutual Assistance on Recovery of Claims relating to Taxes, Duties and Other Claims*, [2010] OJ L 84/1 (*Recovery Directive*) and *Council Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation*, [2011] OJ L 64/1 (hereinafter *Cooperation Directive*). Both Directives in their preambles, place reliance on multiple legal bases as ‘having regard to the Treaty on the Functioning of European Union, and in particular Articles 113 and 115 thereof’. Insertion of an additional legal base (TFEU, above n 4, art 113) is factually indicative of conferring competence in addition to what is required for direct taxes, and hence render both these directives equally applicable to indirect taxes.

³¹ *Recovery Directive* and *Cooperation Directive*, *ibid.* The *Cooperation Directive* has undergone some key amendments in view of the ongoing European campaign against Base Erosion and Profit Shifting (BEPS); see, eg, amendments noted in below n 37.

³² The Council of EU (represented by relevant minister of each Member) together with the EU Parliament constitute the legislature of the Union.

³³ *Council Directive 90/435/EEC on Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*, [1990] OJ L 225/6–9 (as amended from time to time) (here referred to as *Parent–Subsidiary Directive*).

³⁴ *Council Directive 90/434/EEC on Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges concerning Companies of Different Member States*, [1990] OJ L 225/1–5 (as amended from time to time) (here referred to as *Mergers Directive*).

would tax the difference between book value and sale value of assets. The deferral, to mitigate double taxation that might have happened pursuant to differences in timings of taxation, ensures that both Members tax at the same time when actual sale of assets takes place. The Directive also accommodates the possibility of transfers involving a third Member, providing that the state of transferring company either to forego its taxing right or while taxing the gain allow a credit for the taxes that the permanent establishment would have paid on these gains.

The *Interest and Royalty Directive*³⁵ makes it obligatory for the state of the paying company to refrain from charging withholding tax. The directive also resolves the problem of double taxation by prohibiting withholding tax on subsidiary companies and permanent establishments located in the source states. This is to eliminate issues of limitation of credit method that ordinarily stem from excessive tax deductions in source states relative to the actual tax bill of the given firms in residence states. The scope of the legislation is also limited in a manner similar to that of the Parent–Subsidiary Directive.

The Savings Directive:³⁶ This directive has recently been repealed.³⁷ As long as the legislation remained operative, it extended to taxation of interest income of individuals. Members, in their capacity of source country, would not, in general, impose withholding tax on interest income of individuals. Rather, the information would be passed on to the residence country for tax purposes. On transitional grounds, a few Member States were entitled to levy withholding tax on interest income; in those cases, the residence states were obliged to apply credit method to avoid double taxation. If the tax liability was less than the tax withheld at source, the residence states had to refund the excess to individual taxpayers. The legislation was limited to income from interest earnings.

The *Anti-Tax Avoidance Directive*³⁸ is the most recent addition to the EU tax legislation. It builds on some of the insights from the Base Erosion Profit Shifting (BEPS) project of the OECD and also serves as an interim measure towards a Common Consolidated Corporate Tax Base (CCCTB) system, since the directive also covers certain international aspects of anti-tax avoidance in the CCCTB draft.³⁹ The legislation limits the

³⁵ Council Directive 2003/49/EC on the Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, [2003] OJ L 157/49–54 (as amended from time to time) (here referred to as *Interest-Royalty Directive*).

³⁶ Council Directive 2003/48, 2003 on Taxation of Savings Income in the Form of Interest Payments, [2003] OJ L 157/38–48 (*Savings Directive*). The Directive has been repealed; see below n 37.

³⁷ Savings Directive has been repealed on 10 November 2015 through a legislation adopted under Council Directive (EU) 2015/2060 [2015] OJ L 301/1–4. The repeal was consequential to another amendment brought in the Cooperation Directive, above n 29; for new addition to this directive, see amendment brought through Council Directive 2014/107/EU amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation; for this amendment, [2014] OJ L 359/1–29.

³⁸ Council Directive (EU) 2016/1164 laying down rules against avoidance practices that directly affect the functioning of the internal market, [2016] OJ L 193/1–14 (here referred to as *Anti-Tax Avoidance Directive*).

³⁹ The Commission has planned to re-launch the CCCTB proposal in phases. This phase-wise approach, *inter alia*, seeks to build in several ways on anti-tax avoidance measures foreseen under the BEPS guidelines; see, eg, *European Commission Communication: A Fair and Efficient Corporate Taxation in the European Union: 5 Key Areas for Action*, COM(2015) 301 Final (17 June 2015), available at <<https://ec.europa.eu/priorities/sites/beta-political/>

deductibility of interest for multinationals, provides a framework to tackle hybrid mismatches, sets out rules for exit taxation and controlled foreign companies, and lays down general anti-abuse rule to deny taxpayers the benefit of abusive tax arrangements.

III FACTORS AFFECTING LEGISLATIVE POWERS ON DIRECT TAXATION

Leaving aside the political dimension (the unanimity requirement), three constitutional factors could impact the EU powers to formulate income tax policy. The first is the primary source that provides legislative force to the Union actions in terms of a submerged mandate inherent in the single market principle and freedom clauses. The second is an authority vested in a non-tax-specific legal basis to intervene into those national (tax) provisions that impede the institution of single market. The third is a factor that otherwise does not confer the legislative competence in itself, but rather impacts legislation through its regulatory character. This last aspect oversees the justification and reasoning of an intended EU action, and restricts undue intervention in national (tax) systems through a constitutional framework under the principles of subsidiarity and proportionality, as explained in the final segment of this Part.

A Powers of Implicit Nature

The fact that it is buried in other powers (underneath the freedom clauses) only may limit the legislative competence on direct taxes. The powers to legislate are derived indirectly from the constitutional obligations to institute internal market. The implicit character might have at least two major implications for the policy area in question. First, an EU-level action in this area has to enter into the territory of the doctrine of derived powers. The restrictive designs generally adhering to the doctrine in extending powers from the principal framework to the derivative one are explicable.⁴⁰

Second, and more evident, is the fact that the idea of an internal market and its related principles, on which the income taxation powers mainly rely, are dynamic concepts – that is, ever-evolving since the founding days. For instance, the fundamental freedoms, the core elements constituting common market, had yet to unfold in the transitional period (12–15 years) envisioned by the EEC system when founded.⁴¹ Unless the transitional episode were over and, in theory, the objectives successfully attained, the derived powers conditional upon them (for example direct taxation) would have little meanings. Once the specified transitional period is over, the concept of the single market would attain real meaning, to the extent of realisation of the initial tasks, and so would the corresponding powers originating from it. Likewise, whenever new spheres of influence or policy areas were gradually added for EU-level actions, or the existing ones increasingly expanded

files/com_2015_302_en.pdf> (last accessed 18 June 2015); see also the accompanying document European Commission Staff Working Document: Corporate Income Taxation in the European Union, SWD(2015) 121 Final (17 June 2015).

⁴⁰ See, eg, Antonio Tizzano, 'The Powers of Community' in Antonio Tizzano (ed) *Thirty Years of Community Law* (Commission of the European Communities, 1981) 47 (referring to the complexities of application of the doctrine from judicial perspective).

⁴¹ See EEC Treaty, above n 4, art 8; the clause envisioned a period of 12–15 years for gradually establishing the common market in accordance with the scheme of (the then) given policy areas when founded in 1957.

through various treaty amendments,⁴² the status of the single market over time would reach an advanced stage. With the assigned objectives of integration gradually accomplished in the expanded policy sectors, the market unification would take a new turn, and so, too, the scope of the implicit derivative powers dependent on market integration.

Thus the changing dynamics of conferral of implicit power in the area of direct taxes – a key lawmaking area – is not compartmentalised in the text of the EU constitution. Instead, it remains implicit and has evolved without textual changes in the EU constitution. This implied power becomes comprehensible when traced as a common evolutionary thread running from past to present to future, as discussed in Part IV.

B Non-Specialised Legal Basis

As a vital tool of legislative apparatus, a general legal basis (as opposed to a specialised basis) may at first glance appear to be equipped with powers of a restrictive character that might limit a wide-ranging supranational action in this area. This section explains how a non-specialist general legal basis applied to an (implicit) income tax regime could substantially differ in outcomes, compared with a specialised one, such as an area-specific (explicit) legal basis meant for legislation in the VAT regime – a sister policy area.

(a) Legal Basis to Legislate in the Area of Direct Taxes

In the absence of express mention of direct taxes, how could one locate a legal basis for legislation in direct taxes? This aspect of the discussion – the evolution of EU tax powers – is discussed in Part IV of this article. This segment considers the legacy that might devolve from such a legal basis, if established – what the regime could possibly inherit, in terms of a mandate of prescriptions and proscriptions for tax legislation. The constitutional provision (Article 115 TFEU)⁴³ invoked to date as legal basis to legislate direct tax rules, set out in EU law reads as (emphasis added):

The Council shall, acting *unanimously* in accordance with a special legislative procedure and after consulting the European Parliament and Economic and Social Committee, issue *directives* for the *approximation* of such laws, regulations or administrative provisions of the Member States as *directly affect* the establishment or functioning of the internal market.

A legal analysis of the text reveals that the expression ‘unanimously’ refers to the requirement to have a unanimous consensus of all Members. The expression indeed manifests the political sensitivity of tax legislation in indicating that no Member wants a tax legislation to be adopted without its will. Undoubtedly, this is a serious impediment to European-level tax legislation. This study, however, does not focus on the politics of

⁴² On addition/expansion of areas of EU influence, see below nn 85–8.

⁴³ Since actual legislative measures taken in the field of direct taxes were mostly adopted before TFEU came into force under Lisbon Treaty, the legal bases of these legislative instruments have equivalents of TFEU, above n 4, art 115; that is, the (then) legal bases were: EEC Treaty, above n 4, art 100 for Parent–Subsidiary and Mergers Directives, above nn 33–34 and EC Treaty, above n 4, art 94 for Interest-Royalty and Savings Directives, above nn 35–36.

European taxation; rather, its key concern remains the legal and constitutional dimension of EU tax powers, as pointed out in the introductory part.

Besides that expression, at least three other expressions in the text, instrumental to an EU-level tax mandate, merit greater attention: ‘directives’, ‘approximation’, and ‘directly affect’. Of all the legislative forms that are binding in character, the ‘directives’ format may take precedence over others, given the sensitivity of national treasuries to EU tax measures. That is because directives require transposition into national statutes. Thus, directives can not only intervene in the national laws but, at the same time, also provide Members with a welcome breathing space in an area of heightened politics and sovereignty concerns. Other forms of legislation, such as Regulation or similar instruments, having a stronger impact (deeper national intervention), could better correspond to an area of extensive and explicit EU competence, but that is clearly not the case with the policy area in question.

‘Approximation’ (relative to the term ‘harmonisation’ used for indirect taxes), likewise inherits softer connotations of intervention in national (tax) powers.⁴⁴ The expression ‘directly affect’, in the same vein, underpins a restraint on intrusion into national (tax) rules and subjects an EU action to it if – and only if – Members’ (tax) rules ‘directly affect’ the internal market. This is unlike the case with legal bases to adopt legislation on indirect tax laws and other national laws of non-fiscal nature.⁴⁵ In both the latter situations, legal bases empowered to initiate integrative measures are not necessarily pre-conditioned as to whether a given (national) law ‘directly affects’ the internal market or otherwise.

To sum up, in exercising European supranational legislative powers, the in-built legal plan of (general) legal base is not sufficiently self-contained to impart greater or deeper force to EU-level actions on its own. It has empathy to house multiple traits for different policy areas, but it could be manifested only when the areas are spoken of in the EU law, which is not the case with direct taxes. No doubt the nature of a general legal platform may also not extend beyond the traditional dynamism, yet an action based on (implicit) platform relying, in turn, on implicit powers, seemingly adds to the convolution of the EU mandate to take actions in the area of direct taxes.

How a general legal basis (of direct tax legislation) inherits a different scope for potential Union actions relative to an explicit and specialised one as is in the case of VAT is illustrated in the following part.

(b) Comparison with Legal Basis Meant for Integration of VAT Law

Unlike direct taxes, right from the inception of European Community, indirect taxes were allocated an explicit segment in the European law, titled ‘Tax provisions’.⁴⁶ To harmonise indirect taxes, a specialised legal basis also existed from the beginning stating that ‘The Commission shall consider in what way the laws of the various Member States

⁴⁴ From the founding days (under the EEC Treaty) to date (under the Lisbon Treaty), the words ‘harmonisation’ and ‘approximation’ have been employed for, respectively, integration of indirect taxes and direct taxes; the former embedded a specialised legal basis while the latter imported a general legal basis. See further below n 53.

⁴⁵ For indirect taxes, see below Part III(B)(2); for other laws of non-fiscal nature, see TFEU, above n 4, art 114 (equivalent to EC Treaty, above n 4, art 95 and Maastricht EC Treaty, above n 4, art 100a).

⁴⁶ EEC Treaty, above n 4, arts 95–99.

concerning turnover taxes, excise duties and other indirect taxes... can be harmonised in the interests of the common market. The Commission shall submit proposals to the Council, which should decide by unanimous vote'.⁴⁷ A distinct chapter titled 'Tax provisions' was also devoted to indirect taxes under the subsequent versions of the European (then Community) law⁴⁸ and so it remains under the current EU law.⁴⁹

With this brief preface on the constitutional agenda of indirect taxes, the EU-level power to intrude deeper into national VAT codes and to take wider EU-level actions in the VAT regime is fairly comprehensible. The existing clause (Article 113 TFEU)⁵⁰ meant to serve as a legal basis to adopt VAT legislation, reads as (emphasis added):

The Council shall acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and Economic and Social Committee, adopt *provisions* for the *harmonisation* of legislation concerning *turnover taxes, excise duties and other forms of indirect taxation* to the extent that such *harmonisation* is necessary to ensure the establishment and functioning of internal market and to *avoid distortion of competition*.

The requirement of unanimous consensus of Members, similar to one for direct taxes, is a prerequisite to adopting legislative acts in the field of indirect taxes. Why unanimity hinders the adoption of European VAT law much less than it does for direct taxes, is not the issue at hand. However, it can fairly be attributed, in varying degree, to the political willingness of the Members and the competence and explicit character of powers laid down in the EU constitutional scheme right from the foundational times.⁵¹

In order to compare and analyse the legal bases on which to legislate two forms of taxation, at least four expressions emphasised in the above legal text are worth attention. First, the format of VAT legislation, contrary to direct taxes, is not confined to directives. The word 'provisions'⁵² gives the law-maker liberty to adopt legislation beyond a

⁴⁷ EEC Treaty, above n 4, art 99.

⁴⁸ Maastricht EC Treaty, above n 4, arts 95–99; EC Treaty, above n 4, arts 90–93.

⁴⁹ TFEU, above n 4, arts 110–113.

⁵⁰ TFEU, above n 4, art 113 replaced EC Treaty, above n 4, art 93; the latter in turn was preceded by EEC Treaty, above n 4, art 99. All these three provisions are substantially almost similar. The legal basis of main legislative measure taken for VAT (Old VAT Directive, above n 10) refers to dual legal basis by placing reliance on double legal provisions, ie, EEC Treaty, above n 4, arts 99–100. The instrument was subsequently replaced by the existing VAT law (Existing VAT Directive, above n 9) having a single legal basis, ie, EC Treaty, above n 4, art 93.

⁵¹ See, eg, above nn 45–48 and the accompanying text.

⁵² By virtue of the expression 'provisions' used in the legal foundation, TFEU, above n 4, art 296, para 1 (see above n 29) becomes applicable to it. Thus the scope of choice to use legal tools, unlike direct taxes, can no longer be restricted exclusively to Directives. Based on the content and depth required at the Union level (proportionality), an action can also be enforced in the form of a Regulation or Decision to intervene national VAT regimes. Notwithstanding that the current instrument of VAT law in force is a Directive (see, Existing VAT Directive, above n 10), the scope of its application and the level of integration of national (VAT) regimes achieved by it is unrivalled to similar tool(s) adopted for direct taxation; for brief discussion so far as relatively enhanced scope of EU actions in VAT is concerned, see also below nn 54–55; for direct tax Directives, see above Part II(C) At the same time, irrespective of the fact that current core legislation on Union VAT law in force is in the form

directive, using other forms such as Regulation or Decision. Second, the legal basis at hand considers ‘harmonisation’ of indirect taxes instead of ‘approximation’. The former seems to signify a relatively deeper penetration into national laws (enhanced integration) when viewed in the context of European constitutional scheme.⁵³ Third, it intensifies the integrative scope by assigning ‘harmonisation’ (over and above the single market objective to) an additional but explicit objective to ‘avoid distortion of competition’.⁵⁴ Likewise, when contemplating harmonisation initiatives as such, there is no legal obligation to pre-establish whether the national (VAT) laws ‘affect’ the internal market ‘directly’ (as is the pre-condition under Article 115 TFEU) or otherwise.

All these features, in aggregate, craft powers in such a way that supranational actions could permeate deeper into national VAT codes to institute a wider and deeper level of harmonisation at EU-level. As a result, contrary to direct taxation, the specialised and explicit legal basis for indirect tax laws ends up in (considerably) enhanced scope for Union-level VAT policymaking. This argument is also evidenced by the scale of the VAT legislation adopted to date.⁵⁵ The European Commission’s recent and prospective VAT

of a Directive, the authority conferred upon the legal basis for VAT to select and adopt other forms of legislative tools (Regulations, Decisions, etc) remains equally intact.

⁵³ According to McLure, above n 5, 379–80, ‘the term “harmonization” means different in the EU and the US (“Coordination” is the more common word used in the US)’. Citing Linda Senden *Soft Law in European Community Law* (Hart Publishing, 2004) 45–6, McLure identifies three related concepts used in the EU discussions of tax policy: harmonisation, approximation, and unification, and says that ‘harmonization – and thus by implication approximation – refers to integration processes that do not lead to the creation of uniform law, but rather to the creation of common frameworks or legal rules establishing a common goal, which leave room for divergent national specifications’.

My analysis differs slightly from this interpretation by making a fine distinction between ‘approximation’ and ‘harmonization’ on grounds set out in the peculiarity of two legal bases (EEC Treaty, above n 4, arts 99–100). Whereas EEC art 99 was applicable exclusively to turnover taxes, excise duties and other indirect taxes, EEC art 100 was not intended to be direct tax-specific. By scope, the latter, as a general legal basis, was extendable to all laws (and hence all powers) of Members directly affecting the common market. Both expressions essentially involve integration (intervention) of national laws (powers). The use of one expression covered a single, too explicit area (indirect taxes), while the second expression covered several implicit (as well as explicit) areas. Against this backdrop, ‘approximation’ relative to ‘harmonisation’ plausibly hints at a degree of *reluctance* in accessing national laws.

McLure’s observation about harmonisation meaning different things in the EC and the US seems justified when viewed in the wider US context where, unlike the EU, harmonisation and approximation are taken as one and the same. For instance, the US version in English translates the title of section 3 of the EEC Treaty as ‘Harmonisation of Laws’ (see, eg, *Treaty Establishing the European Economic Community* (October 1957) 51 *American Journal of International Law* 900), whereas the European English version translates the same title of the EEC Treaty as ‘Approximation of Laws’. Nevertheless, the use of word harmonization in a general sense to represent allied concepts may also not be misleading unless an EU legal context otherwise so requires.

⁵⁴ The additional objective codified in the legal foundation proportionally delegates enhanced scope to harmonise national VAT laws. To ‘avoid distortion of competition’ (in addition to the core single market objective), the clause also takes into account constitutional provisions laid down in chapter (titled) ‘Rules on competition’ (TFEU, above n 4, arts 101–109). This entrusts additional sanction to this base and assigns wider capacity to enact expansive legislative acts.

⁵⁵ Existing VAT Directive, above n 10; legislation to harmonize national VAT regimes under this Directive is an incomparably sweeping enactment compared to those on direct taxation

agenda is also indicative of this rationale. For instance, based on studies and consultations,⁵⁶ a draft legislation to adopt a common VAT return across the single market was on cards in the recent past.⁵⁷

C Subsidiarity and Proportionality

1 In General

The subsidiarity rule, a constitutional provision superimposed on the balance of powers, governs the exercise of legislative actions in all areas of non-exclusive EU competences. Since its introduction in the EU law under the Maastricht Treaty,⁵⁸ the provision has been the subject of considerable academic discourse, and a plethora of literature is available on it.⁵⁹ The distinctive clause, when added to the EU (the then Community) law, read as:

(above Part II(C)). The former sets out an EU-wide detailed VAT regime and also encompasses legal acts of second generation; eg, *Council Implementing Regulation 282/2011/EU laying down Implementation Measures for Directive 2006/112/EC on the Common System of Value Added Tax*, [2011] OJ L 77/1. Factually, the Implementing Regulation is 'second generation' tool (and a non-legislative delegated act in terms of TFEU, above n 4, art 291) of the legal basis meant for VAT law. EC Treaty, above n 4, art 93 (now TFEU, above n 4, art 113) created the (Existing VAT) Directive, above n 10 and then the (art 397 of the existing VAT) Directive created Implementing Regulation. The same is the case with a number of VAT Implementing Decisions addressed to various Members in pursuance to mandate derived from art 395 of Existing VAT Directive (eg *Council Implementing Decision 2013/54/EU to the Republic of Slovenia on Certain Measures concerning Existing VAT Directive*, [2013] OJ L 22/15).

⁵⁶ See, eg, *European Commission Specific Contract No. 9: Study on the Feasibility and Impact of Common EU Standard VAT Return*, TAXAUD/2011/DE/329 Final Report (February 2013), <http://ec.europa.eu/taxation_customs/common/publications/studies/index_en.htm> (last accessed 26 August 2015).

⁵⁷ *European Commission Proposal for a Council Directive to Amend Directive 2004/112/EC on the Common System of VAT as regards Standard VAT Return*, COM(2013) 721 Final (October 2013).

⁵⁸ Maastricht EC Treaty, above n 4, art 3b.

⁵⁹ On diverse views and interpretations on application of principles of subsidiarity and proportionality, see, eg, Ib Martin Jarvad, 'Subsidiarity and Autonomy' (1994) 19 *History of European Ideas* 797-803; Deborah Z Cass, 'The Word that Saves Maastricht? The Principle of Subsidiarity and the Division of Power within the European Community' (1992) 29 *Common Market Law Review* 1107; Koen Lenaerts, 'The Principle of Subsidiarity and the Environment in the European Union: Keeping the balance of Federalism' (1994) 17 *Fordham International Law Journal* 846; Grainne de Bruca *Reappearing Subsidiarity's Significance after Amsterdam* (Harvard Jean Monnet Working Paper No. 7 1999), available at <www.jeanmonnetprogram.org/archive/papers/99/990701.html> (last accessed 12 December 2016); Thomas Horsley, 'Subsidiarity and the European Court of Justice: Missing pieces in the Subsidiarity Jigsaw?' (2012) 50 *Journal of Common Market Studies* 267; Andrea Biondi, 'Subsidiarity in the Courtroom' in Andrea Biondi et al (eds) *EU Law after Lisbon* (Oxford University Press, 2012) 213; P J Devine (ed) *Competitiveness, Subsidiarity and Industrial Policy* (Routledge, 1996); G M M Gelauff et al (eds) *Subsidiarity and Economic Reform in Europe* (Springer, 2008); Aurelien Portuese, 'The Principle of Subsidiarity as a Principle of Economic Efficiency' (2011) 17 *Columbia Journal of European Law* 231; Paul Craig, 'Subsidiarity: A Political and Legal Analysis' (2012) 50 *Journal of Common Market Studies* 72; Gareth Davies, 'Subsidiarity: The wrong idea, in the wrong place, at the wrong time' (2006) 43 *Common Market Law Review* 63.

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.

Later, a protocol, and a declaration were added to the EU law to explain the procedure on application of the subsidiarity principle.⁶⁰ These provisions in substance, together with an amended protocol on their application, remain part of the current version of EU law adopted under the Treaty of Lisbon.⁶¹ As an exceptional constitutional tool, it governs the exercise of EU powers in areas of non-exclusive Union competences. The scope of the subsidiarity principle does not extend to the conferral of powers, but rather performs a regulatory function. The subsidiarity principle does not confer powers to the EU. It may, however, expand or confine supranational actions while the Union exercises its shared-powers – the powers that are inscribed elsewhere in the EU law.⁶² Every legislative act in related areas, including taxation, must therefore undergo the test set forth in this principle. A Union action must pass that test; the EU cannot take legislative action unless (1) the Members' action cannot sufficiently realise the objectives; (2) the Union can perform better in doing the same (3) by reason of scale or effects of the action; and (4) any intervention by the EU should strictly not exceed the limit of attaining objectives (proportionality principle).

2 In Taxation

The subsidiarity yardstick in the tax policy area may largely be applicable at the interface of law and economics rather than law and politics. The addition under the Amsterdam Treaty on how to apply subsidiarity sees it to be 'a dynamic concept'⁶³ applicable to the legislative process to achieve objectives laid down in the EU constitution. The principle encapsulates diverse notions: the economic dimension, in terms of a cost–benefit analysis is apparent from the text of the clause, since it invites an EU action when a similar action at the level of national governments is inefficient. Besides the economic dimension, subsidiarity has been termed 'first and foremost a political principle'.⁶⁴ Further, the

⁶⁰ Protocol and Declaration on subsidiarity was added through the Amsterdam Treaty, above n 4, [1997] OJ C 340/1, 105–107, 140.

⁶¹ See, TEU post-Lisbon, above n 4, art 5(3) (on principles of subsidiarity and proportionality), Protocol No. 2 (on the application of these principles) annexed to the Lisbon Treaty, [2010] OJ C 83/1, 206.

⁶² According to Portuese, above n 59, 233, 'this principle does not convey whether or not the EU has the power to act with regard to a specific policy'; on impacts of subsidiarity principle in relation to legislation, see also, European Commission Report: The Adaptation of Community Legislation to the Subsidiarity Principle, COM(93) 545 Final, 1 (September 1993) (*Commission Report*) (explaining that 'Its function is not to distribute powers ... The aim of the subsidiarity is, rather, to regulate the exercise of powers and justify their use').

⁶³ Protocol, above n 60, para 3; the provision also states: 'It allows Community action within the limits of its powers to be expanded where circumstances so require, and conversely, to be restricted or discontinued where it is no longer justified'.

⁶⁴ Commission Report, above n 62.

principle is denoted ‘a state of mind’⁶⁵ (political dimension) and ‘a sort of rule of reason’⁶⁶ (legal, political, economic dimensions).

The existence of a relatively scarce case law on subsidiarity is another remarkable feature; the provision has yet not undergone the process of extensive judicial review.⁶⁷ As a multidimensional concept, it is ‘one of the most debated, analysed, criticized, despised and, in few cases, loved concepts of EU law’ in the academic world.⁶⁸ The several aspects of the subsidiarity including its comprehensive discourse in relation to taxation are beyond the scope of this article. I do, however, briefly explore its regulatory interplay with the EU legislative powers in relation to direct taxes.

The argument that the subsidiarity rule takes lego-economic dimension to oversee a Union action in taxation takes its backing from the birth place of this rule within the EU law. When the policy area of environment was being added to the actionable spheres of the EU (then the Community) under the Single European Act (SEA),⁶⁹ subsidiarity (without being named) was embodied in the EU law for the first time, and was applicable exclusively to Union actions in the field of environment.⁷⁰ As within the newly assigned EU power (on environment) it was possible that certain supranational actions could encroach upon some Member States without their consent, by virtue of majoritarian voting,⁷¹ a subsidiarity check could, therefore, mitigate their concerns to a certain extent. The subsequent introduction of a subsidiarity calculus extendable to all non-exclusive EU powers under the Maastricht Treaty could also be a manifestation of similar national concerns about losing sovereignty by virtue of introducing majoritarian voting to various policy regimes in those times.⁷² If the subsidiarity check is there to cater for sovereignty fears raised by the ease of voting, the political dimensions of the rule are obvious.

Nevertheless, in the realm of taxation, the requirement of unanimous voting remains intact. That being the case, the lego-political role of the provision cannot be argued forcefully, since in the presence of unanimity rule for an EU legislation on direct taxes, national governments still retain the power to veto any supranational action deemed to be *unwarranted intrusion*. Against that backdrop, subsidiarity might rather seem to be a superfluous notion for taxation, if explained strictly in political terms. This is where the lego-economic character of this dynamic principle comes into picture. A legal rationale of subsidiarity that takes into account economic parameters better explains the application of this principle in matters concerning EU-level tax legislation. Further, application of

⁶⁵ Ibid, 2.

⁶⁶ Ibid.

⁶⁷ Craig, above n 59, 80 (observing that since the subsidiarity principle put in place under the Maastricht Treaty (see above n 58), there had been hardly ten substantial cases challenging the provision before the ECJ in almost 20 years).

⁶⁸ See Biondi, above n 59, 213.

⁶⁹ See amendments to the EEC Treaty through SEA, above n 4, arts 130r, 130s.

⁷⁰ SEA, above n 4, art 130r(5).

⁷¹ Some of the Community actions on environment could be contemplated by qualified majority voting; see SEA, above n 4, art 130s, para 2. This could leave room for an act that some (opposing minority) Members might be concerned of. The subsidiarity insertion, to an extent, could potentially address it.

⁷² Amendments under the SEA introduced the principle of qualified majority voting (in contrast to the unanimity principle) to several legal bases for EU actions in an array of policy areas; eg, SEA, above n 4, arts 28, 57(2), 70(1), 84(2), 100a, 100b, 118a, 130q(2) (in conj. with arts 130k, 130l, 130m, 130n, 130p), 130s, para 2.

subsidiarity rule in tax matters takes precedence at the intersection of law and economics over law and politics notion. The criteria set out under the subsidiarity clause would thus predominantly take into account arguments of economic efficiency and a cost–benefit analysis to assess measures such as those meant to reduce transnational spillover effects of tax policy or tax-induced distortions in the internal market.⁷³ To sum up, the overseeing effect of subsidiarity as to ‘expansion or restriction’ of an EU action in the area of direct taxes would be largely determined by economic efficiency rather than politics.

IV EVOLUTION OF IMPLIED COMPETENCE TO LEGISLATE IN THE FIELD OF DIRECT TAXES

Nothing in the legislative regimes of the EU constitution makes sense as clearly as in the light of evolutionary developments of power equilibrium. Supranational governance has evolved in the European jurisdiction, making it difficult to answer the question, who – whether Members or the Union – governs a particular policy area, because this changes over time.⁷⁴ In relation to direct taxation, it was argued in Part III(A) that the powers implicit in single-market principles are dynamic and mobile in nature. In fact, all the three factors that were considered as relevant to legislation are not in the least compartmentalised. Considering each factor in isolation as to its potential impact on legislative outcomes might convey some broader outlines, but not the fuller picture of their interaction in the legislative tale.

Tracing the evolutionary path of the growth and allocation of powers in general, and the interplay of factors affecting legislative framework for direct taxes in particular, appears the best way to frame the right perspective here. Further, the atypical role of the three EU organs – the executive (Commission), the judiciary (European Court of Justice), and the legislator (Council) – is also hardly comprehensible in the legislative processes except in the light of peculiar institutional interactions. Thus, to facilitate such an analysis, in what follows, I take an excursion of contextual developments behind the shifting balance of powers in the European legal system in the area of direct taxes.

A *The Foundational Phase*

The EEC Treaty, founded generally along the lines of an international organisation, ostensibly kept direct taxes away from the purview of supranational meddling, in particular, relative to tariffs and turnover tax regimes.⁷⁵ With no conscious policy agenda on its integration in the founding periods, the Treaty, *prima facie*, paid little attention to direct taxation in express terms. The one and only explicit mention of direct taxes found

⁷³ See, eg, Stephen Smith, ‘Subsidiarity’ and the Co-ordination of Indirect Taxes in the European Community’ (1993) 9 *Oxford Review of Economic Policy* 70, 92.

⁷⁴ Alec Stone Sweet and Wayne Sandholtz, ‘European integration and supranational governance’ (1997) 4 *Journal of European Public Policy* 297, 299 (observing, in the context of Community’s seats of policy making and competences to govern, that ‘within the same policy sector, the answer to the question, ‘who governs?’, has changed over time’); see also Shafi U Khan Niazi and Richard Krever, ‘Is integration of taxation possible in the EU?’ (2015) 30 *Australian Tax Forum* 457, note 11.

⁷⁵ Unlike direct taxes, abolition of customs duties between Members (EEC Treaty, above n 4, arts 12–17), and establishment of common customs tariff (EEC Treaty, above n 4, arts 18–29) were amongst the most explicit supranational competences. On similar powers to harmonize VAT and indirect taxes, see above Part III(B)(2).

its place in the last chapter (General and Final Provisions) of the Treaty.⁷⁶ Intuitively, this reference too, commensurate with the (then) status of the polity akin to an international organisation, was nothing more than a recommendation to the Members to explore channels under public international law to avoid double taxation.

During the 1960s when, based on the land mark ECJ rulings, the EEC Treaty was transforming into a constitution covering areas such as shaping its supremacy over national laws,⁷⁷ the indirect taxes, based on the explicit Treaty powers, also witnessed some pioneering legislation on harmonisation of national turnover taxes.⁷⁸ No analogous EU actions in the area of direct taxes were observed in those times, however. The difference between the two tax regimes could fairly be attributed (besides the political willingness of Members) to the absence of any specialised legal basis or any expressed supranational powers on direct taxes in the Treaty.

The only supranational legal clout that existed in the foundational periods could be traced to ‘buried objectives’ deep down in the EEC Treaty. The objectives, *inter alia*, stated that ‘the activities of the Community shall include ... the approximation of ... [Members’] laws to the extent necessary for the functioning of the Common Market’.⁷⁹ No doubt the objective did not exclusively target direct taxes; rather it encompassed a cohesion of all (national) laws in general, to the extent of their potential damaging effects to the common market. Direct taxation could, therefore, be considered as one of those (sub-textual) laws which the common market objectives (inherently) might intend to approximate in due course. Yet, several factors could substantially impede *deciphering* of tax power that otherwise existed submerged under the single market notion.

B Direct Taxation in the ‘Back Seat’?

At the time of the first major revision under the SEA, some of the amendments to the EEC Treaty also signify key underlying intents of the drafters towards potential EU powers (or lack thereof) in fiscal matters, particularly on direct taxes. The legal basis meant to enact directives in the policy area of direct taxes, which otherwise had general features to accommodate several sectors, was constrained to narrow down so as to become applicable to fewer areas including direct taxes.⁸⁰ This constraint was created

⁷⁶ EEC Treaty, above n 4, art 220, at 87 that was retained as EC Treaty, above n 22, art 293 (before being repealed under the Treaty of Lisbon).

⁷⁷ For example, *Costa v ENEL* (6/64) [1964] ECR 585 (assigning supremacy to the EU law over national laws). On the principle of direct effect that also lies at the core of the constitutionalisation process, see *Van Gend en Loos*, [1963] ECR 1, above n 9. On more details of principle of direct effect and some major doctrines of the initial phase, see De Witte above n 9. On judicial developments regarding ‘constitutionlaization’ of EU law, see, eg, J H H Weiler, ‘The Transformation of Europe’ (1991) 100 *Yale Law Journal* 2413.

⁷⁸ On explicit provisions concerning indirect taxes, see above n 46; on pioneering legislative acts on turnover taxes, see *First Council Directive 67/227/EEC on the Harmonization of Legislation of Member States concerning Turnover Taxes*, [1967] OJ 71/1301, and *Second Council Directive 67/228/EEC on the Harmonization of Legislation of Member States concerning Turnover Taxes*, [1967] OJ 71/1303.

⁷⁹ EEC Treaty, above n 4, art 3(h).

⁸⁰ Textually, the powers vested in existing general legal base (EEC Treaty, above n 4, art 100) and its application to all laws affecting common market remained intact. However, since insertion of a new legal basis (SEA, above n 4, art 100a), a number of areas would automatically prefer legislation through the new basis over the existing one. The preferential value of the new legal basis would rest in its voting ease as well as flexibility to

without bringing any textual change to the legal basis in question; but rather within the same part of the constitution (titled as approximation of laws), another legal basis was crafted and, in chronological order, placed immediately next to the (general legal) basis considered for direct taxes.⁸¹ The new legal base, also designed to be somewhat general in character to legislate the EU-level acts in multiple policy areas, operated differently from the pre-existing (general) legal base meant for approximation of (national) laws on direct taxes. Unlike the older clause that served as a potential legal basis for EU actions in an array of areas including direct taxes, the new legal basis was equipped with a 'legislative ease' (no unanimity requirement), and could also adopt multiple legislative forms (not confined to directives).⁸² Further, the new legal basis also did not lay down a pre-condition that an EU action could be taken only if a national policy 'directly affect[s] the internal market'. Thus, in the post-SEA era, intended EU actions in various policy areas would positively prefer to invoke the new legal basis, with its 'convenience plan', over the existing one. This indeed would render the old legal basis applicable only to those limited areas not covered by the new basis. For instance, the fiscal matters including taxation were debarred from the purview of the new basis,⁸³ and an EU-level action on direct taxes required (and still require) the use of already existing general legal bases. The new legal basis also excluded indirect taxes from its purview; however, (besides unanimity), it had little impact on indirect tax legislation, since this policy area already had a specialised legal basis of its own (Part III(B)(2)).

Another feature of the SEA-induced amendments in the EEC Treaty was that they prioritised certain policy areas including indirect taxes and set out a project for their time-bound integration so as to gradually establish a single market.⁸⁴ Direct taxes, covered under the general objective of approximation of laws, was certainly missing from this preferential time-bound sectoral integration plan. The changes inserted through the SEA were indicative of the progressive extensions of EU powers, indicating a *go-ahead scheme* for integration of various areas excluding direct taxes.

Does this imply that EU powers in the area of direct taxes from the EEC Treaty (1957) to the SEA (1986) were subject to inertia? With the foregoing analysis of the Treaty revision, and given the fact that the first ever substantive legislation on direct taxes had yet to materialise even after three decades, the response to this question could possibly be resoundingly in the affirmative. Nevertheless, a closer examination of the overall growth and expansion in EU powers in different policy sectors during the first three decades may shape a rather different response to this question. The picture becomes clearer if one takes into account the derivative nature of powers on direct taxes being

adapt any legal form that might not necessarily be a directive. Hence, after the SEA amendment, the practical use of the existing base would narrow down only to the fiscal matters which were excluded from the purview of the new base (SEA, above n 4, art 100a(2)).

⁸¹ The new legal base (SEA, above n 4, art 100a) was placed next to the pre-existing general legal base (EEC Treaty, art 100).

⁸² SEA, above n 4, art 100a(1).

⁸³ Ibid art 100a(2).

⁸⁴ Ibid art 8a (in conj. With ibid arts 8b, 8c, 100b) authorized the Community to take integrative measures to gradually establish internal market until 31 December 1992 in various sectors (covered under EEC Treaty, above n 4, arts 28, 57(2), 59, 70(1), 84, 99, and under SEA, above n 4, art 100a) including indirect taxes. Notably, direct taxation, covered under the existing general legal base, was missing from the list and therefore excluded from the time-bound integration plan.

‘nurtured’ within its principal framework, that is, in the undergrowth of freedom clauses and the common market – the market that certainly had grown and widely integrated much beyond its foundational status. By correlating the activities on direct taxation taking place at the Commission-level, the European executive organ responsible for initiating of legislative proposals, during the so-called period of inertia in direct taxes may capture a fuller and bigger picture of developments taking place in the European tax landscape.

C Sub-Textual Growth and Emergence of Tax Powers

An incontrovertible assumption about several EU powers is that, to varying degrees, they originate from or, are impacted by, the schema of the common market crafted as a core objective in the constitution. As the market agenda can hardly be precluded from a wide range of policy sectors, several market essentials (powers) could be added to the menu of the market agenda.⁸⁵ It is also plausible that when EU was founded as an international polity in 1957, neither all such ‘menu items’ in the garb of market-based European powers were explicit, nor were they designed to be readily enforceable in one go. At one point in time (EEC Treaty 1957), a few items of the ‘menu’ were active,⁸⁶ while others (were semi-active or dormant and) gradually ‘queuing’ in the undergrowth of imperatives to establish a common market. At another point (SEA 1986), some of those powers ‘due-in-queue’ were added to the ‘activation list’,⁸⁷ leaving behind another ‘updated list-in-waiting’ to be activated later at a certain optimal stage (Maastricht Treaty 1992),⁸⁸ and so forth. Against that backdrop, EU powers to legislate measures in almost all policy areas, in theory, had inevitably to remain ‘mobile’ in the quest of achieving a common market.

⁸⁵ This is what practically transpired if one takes an overview from the EEC to the pre-Lisbon times; Davies, above n 59, 1 (noting that ‘the scope of the Community activity is now so broad that few if any areas of national policy are immune from its effects’).

⁸⁶ See, eg, free movement of goods (EEC Treaty, above n 4, arts 9–11), elimination of customs duties between Members (EEC Treaty, above n 4, arts 12–17), setting up of common customs tariffs (EEC Treaty, above n 4, arts 18–29), elimination of quantitative restrictions between Members (EEC Treaty, above n 4, arts 30–37).

⁸⁷ See, eg, extension in supranational influence to new policy areas in EEC Treaty through amendments under the SEA, above n 4, arts 102a(2) (in conj. with 236), 118a, 130a–130e, 130r, 130s (respectively, on economic and monetary policy, laying down criteria for national laws on health and safety of workers, on roles in regional development and economic and social cohesion, on research and technological development, and on environment). Likewise, harmonisation of turnover taxes, excise duties and other indirect taxes still required unanimity (no change in EEC Treaty, above n 4, art 99). A newly added general legal basis (SEA, above n 4, art 100a) covering a number of policy sectors inserted through these amendments did not require unanimity to integrate national laws; however, fiscal matters (including direct taxation) were excluded from its purview (SEA, above n 4, art 100a(2)). Some of the newly added legal bases however, required unanimity; eg, ESA, above n 4, arts 130q(1) (in conj. with 130i, 130o), 130s, para1.

⁸⁸ See, eg, Maastricht EC Treaty, above n 4, arts 2, 3, 3a. Some of the explicitly added/amended new tasks included common commercial policy, common policies in the spheres of agriculture, fisheries, transport, environment, energy and tourism; measures on movement of persons, avoidance of distortive competition, and strengthening of economic and social cohesion in the internal market (Maastricht EC Treaty, above n 4, art 3); measures leading to the introduction of single currency (Maastricht EC Treaty, above n 4, art 3a), etc. See also Commission Report, above n 62 (reporting that pursuant to the amendments under the Maastricht Treaty, as many as twenty or so activities became open to the supranational actions).

Indeed, this was precisely also the case with EU constitutional powers on direct taxes that factually never suffered from inertia. It was – and to an extent still is – a matter of academic and legal argument to pinpoint where direct taxation could most likely be located in the ‘active, semi-active or awaiting’ items (powers) on the agenda menu (common market).⁸⁹ What follows below is a brief narrative of some of the developments (at the Commission-level)⁹⁰ during the first three decades when, *prima facie*, there had been a widespread vacuum (of EU powers) in terms of non-adoption of legislation on direct taxes.⁹¹

1 *The Initial Period*

Shortly after the EEC Treaty came into force, the Commission appointed a committee to study issues concerning tax harmonisation in the common market.⁹² The report of this committee identified several problems in the field of direct taxes, such as disparities in company tax base and tax rates, withholding tax on dividends, and double taxation.⁹³ The next study conducted by the Commission appeared in 1970; it largely focused on the

⁸⁹ Certainly, the market-led power mobility alone may not necessarily be the ultimate factor in determining sequence of the so called *due-in-queue* or *list-in-waiting* considerations. One cannot ignore political factors (and also whether a given legislation needs majoritarian or unanimous voting) that essentially – to varying degrees in various sectors – have their say in surrendering or retention of national powers. For instance, on question as regards Union powers to legislate in tax policy area, Members’ concerns over potential loss of (taxing) powers and (fiscal) autonomy can fairly be considered as one of the major factors impacting it. The evolution of competence dynamics in the Community law and the political dimension of Members, however, may not be mutually exclusive; in their interplay, both factors inevitably might also, to varying degrees in different sectors, push and impact each other. Since this article, as mentioned in the start, seeks to investigate only competence constraint on EU-level tax policymaking, the political dimension (veto) has thus largely been ignored while analyzing the so called list-in-waiting notion and alike.

The foregoing argument and the analysis to follow in next segment (Part IV(D)) draws upon on and builds on the neo-functionalist theory of European integration developed by Ernst B Hass, *The Uniting of Europe: Political, Economic and Social Forces, 1950–1957* (Stanford University Press, 1958), and then updated, in particular, by Wayne Sandholtz and Alec Stone Sweet *Neofunctionalism and Supranational Governance* (unabridged version) SelectedWorks of Alec Stone Sweet (Yale University, 2012), available at <http://works.bepress.com/alec_stone_sweet/38/> (last accessed 26 August 2015). The major difference is that instead of covering general processes of European integration as theorised by neo-functional model, this article briefly touches upon the policy spillover confined largely to direct tax domain within the framework of European constitutional construct.

⁹⁰ The European Commission, the executive organ of the EU, is responsible for moving draft legislative proposals To the Council for adoption. The role of the Commission is thus extremely important in the legislative history of the EU.

⁹¹ *Council Directive 77/799/EEC concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation*, [1977] OJ L 336/15–20, which features procedural aspects of administrative and assistance matters is not being considered here as a substantive legislative tool of tax integration.

⁹² Report of the Fiscal and Financial Committee (Neumark Report) *The EEC Reports on Tax Harmonization* (an unofficial translation into English language, by Hugh Thurston, International Bureau of Fiscal Documentation, 1963).

⁹³ *Ibid* 134–38, 141–45.

possibility to mitigate economic double taxation in the single market.⁹⁴ The studies undertaken by the Commission contributed to the initial legislative proposals in the field of direct taxes. In fact, the 1970s witnessed the highest-ever legislative proposals on direct taxes submitted by the European Commission to seek consent of the legislator (the Council of EU).⁹⁵

Most of these legislative proposals were aborted in due course.⁹⁶ The failure to adopt tax legislation at that stage could be fairly attributed to the dual constraints noted in Part I, that is, a lack of political will together with controversies surrounding EU powers on tax legislation. In 1975, for example, the Commission submitted a proposal to adopt a directive on harmonisation of corporate tax systems and withholding taxes.⁹⁷ The draft proposed an EU-wide single corporate tax rate (45–55 per cent), a partial imputation credit system with a single rate of tax credit on distributed dividends, and 25 per cent withholding tax rate on dividends (except for parent–subsidiary) in the common market. The proposal met strong opposition from Members in the Council (a political dimension).⁹⁸ For the Council, a complete tax harmonisation could not be attained in absence of an integrated tax base⁹⁹ (a connotation that the proposal was disproportionate to tax powers). The proposed legislation thus could not seek approval of the legislator and was finally withdrawn by the Commission in 1990.¹⁰⁰

Another piece of draft legislation, proposed by the Commission in 1976¹⁰¹ to adopt a directive on arbitration convention for elimination of double taxation between associated enterprises, met a similar fate and failed. This proposal remained pending with the

⁹⁴ A J Van den Tempel *Studies: Corporation Tax and Individual Income Tax in the European Communities*, Competition: Approximation of Legislation Series No. 15 (Commission of the European Communities, 1970).

⁹⁵ During the 1970s, at least six legislative proposals from the Commission seeking adoption as Directives on direct taxation remained pending with the Council; on four of them, see below n 97.

⁹⁶ See, eg, European Commission Proposals for Council Directives: (1) concerning the Harmonization of Systems of Company Taxation and Withholding Taxes on Dividends, COM(75) 392 Final (July 1975); (2) on the Elimination of Double Taxation in Connection with the Adjustment of Transfers of Profits between Associated Enterprises, COM(76) 611 Final (November 1976); (3) on the Application to Collective Investment Institutions of the Council Directive concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes of Dividends, COM(78) 340 Final (July 1978); (4) concerning the Harmonization of Income Taxation Provisions with Respect to Freedom of Movement for Workers within the Community, COM(79) 737 Final (December 1979); (5) on the Harmonization of the Laws of the Member States relating to Tax Arrangements for the Carry-Over of Losses of Undertakings, COM(84) 404 Final (as amended through COM(85) 319 Final) (September 1984); (6) concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in Other Member States, COM(90) 595 Final (January 1991) (respectively *Commission Proposal (1), (2), (3), (4), (5), (6)*).

⁹⁷ Commission Proposal (1).

⁹⁸ J E Brinkman and A O Riecker, 'European Community Taxation: The Ruding Committee Report Gives Harmonization Efforts a New Impetus' (1993) *The International Lawyer* 1061, 1065.

⁹⁹ George Kopits, 'Overview' in George Kopits (ed) *IMF Occasional Paper No. 94: Tax Harmonization in the European Community: Policy Issues and Analysis* (IMF, 1992) 11.

¹⁰⁰ European Commission Communication: Guidelines on Company Taxation, at 10, SEC (90) 601 Final (April 1990).

¹⁰¹ Commission Proposal (2), above n 97 ([1976] OJ C 301/4).

legislator for several years. The Members, sensitive to potential loss of taxing powers and fiscal sovereignty, were reluctant to adopt that legislation. Alongside fiscal concerns, absence of spoken EU tax powers would further add to the controversies in the minds of legislators. To replace this proposed legislation, the Members agreed to institute an arbitration convention to resolve double tax disputes under public international law, outside the EU constitution. While concluding the arbitration convention, the Members took shelter under an advisory provision (now repealed) of the EU constitution.¹⁰² The Commission in the end had to withdraw its proposed legislation in 1996 – twenty years after its pendency before the Council.¹⁰³

The synopsis of legislative endeavours presented above indicates the evolutionary developments of a direct tax regime with the hindsight of three decades of prolonged stagnation. It also suggests that the EU tax power was indeed seeking its locus in the progressively growing European agenda (common market). Instead of passing through legislative inertia, this tale is indicative of the propensity of direct tax measures to ‘search a legal space’ within the ever-evolving and mobile EU powers. It was finally in 1990, when, without any textual amendment in the constitution, European power on direct taxes secured a limited but substantive legal space. That is, a couple of long-awaited legislative proposals sought the approval of the law-maker, resulting in adoption of a narrow but substantive legislation in the field of direct taxes.¹⁰⁴

2 *The Second Period*

In 1992, alongside a shift in constitutional paradigms under the Maastricht Treaty, in the form of new EU powers and the subsidiarity notion,¹⁰⁵ the Commission, a few months from adoption of the pioneering legislation on direct taxes, appointed a high-profile committee to look into the tax-induced distortions in the internal market.¹⁰⁶ The recommendations of the committee (the Ruding Report) appeared in 1992. They included: elimination of double taxation in several forms; a uniform withholding tax rate of 30 percent on dividends, subject to waiver on appropriate tax identification; concerted action by the Commission and Members defining common policy on double tax agreements; a uniform tax base; and a minimum corporate tax rate of 30 percent to plug the harmful effects of the ‘race to the bottom’ approach.¹⁰⁷

¹⁰² The Members, pursuant to EEC Treaty, above n 4, art 220 (predecessor to EC Treaty, above n 22, art 293 before being repealed under the Lisbon Treaty) entered into an Arbitration Convention (90/436/EEC), [1990] OJ L 225/10–24) under the international diplomatic law. The act was also indicative of Members to proceed autonomously (potentially) in disregard to the pending supranational legislation for want of the latter’s authority in the given policy area.

¹⁰³ See [1997] OJ C 2/6.

¹⁰⁴ Parent–Subsidiary and Mergers Directives, above nn 33–34. The Commission proposals on these directives were transmitted to the Council on 16 January 1969 ([1969] OJ C 39/1–2).

¹⁰⁵ Deliberations by the Heads of Member States (Edinburgh Summit, 11–12 December 1992) on the new constitutional plan, and inauguration of subsidiarity rule in the early 1990s; see above n 58 and accompanying text. On additional information regarding extension of competences, see above n 89.

¹⁰⁶ The Committee with Onno Ruding, the Dutch Finance Minister, in chair was appointed by the European Commission as of 25 October 1990 to examine company taxation; Ruding, below n 107, 7.

¹⁰⁷ Onno Ruding *Conclusions and Recommendations of the Committee of Independent Experts on Company Taxation* (European Commission’s Working Document, 1992) 27–40. For views on

While most of these recommendations were widely seen as over-ambitious in political terms,¹⁰⁸ a new impetus to the activities of the Commission in tax policy was nevertheless noticeable in the 1990s. For instance, in an attempt to cleanse the legislative agenda, some of the archaic pending proposals that in due course had lost relevance were withdrawn by the Commission.¹⁰⁹ There was also a visible intensity in the European Commission as it issued recommendations and communications.¹¹⁰ These measures – generally known as a ‘soft law’ approach in EU parlance – are meant to ‘sensitise and orientate’ the Member States towards adopting a harmonious approach before adopting a ‘hard law’ approach that is binding in character. These European approaches resulted into adoption of soft law against harmful tax competition at an informal meeting of the ministers of the Economic and Financial Affairs Council (ECOFIN).¹¹¹ This pioneering soft law in the field of direct taxes, known as Code of Conduct for Business Taxation, exists to this day and is widely considered an influential tool against several harmful tax practices in the common market.¹¹² The momentum generated by the ECOFIN interactions also led the European Commission to revisit the two pending legislative proposals which were later adopted in 2003 as binding law in the form of directives.¹¹³ These were times when fresh plans found

this report, see, eg, Franz Vanistendael, ‘The Ruding Committee Report: A Personal View’ (1992) 13 *Fiscal Studies* 85.

¹⁰⁸ See, eg, KPMG *The KPMG Guide to CCCTB* (KPMG, 2011) 8, available at <www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/ccctb-part1.pdf> (last accessed 24 February 2015).

¹⁰⁹ The proposed Arbitration Convention was withdrawn as it had lost much of the relevance (see above n 103 and accompanying text); the pending legislation such as Commission Proposal (5), above n 97 was withdrawn ([1997] OJ C 2/6). Other withdrawals of 1990s (respectively on 13 April 1993 and 9 September 1992) included Commission Proposals (3), (4), above n 97.

¹¹⁰ See, eg, European Commission Recommendations: (1) 94/79/EC on the Taxation of Certain Items of Income Received by Non-Resident in a Member State Other Than That in which They Are Resident, [1994] OJ L 39/22–28; and (2) 94/390/EC on Taxation of Small and Medium Sized Enterprises, [1994] OJ L 177/1–19; European Commission Communication: The Improvement of the Fiscal Environment of Small and Medium Sized Enterprises, COM(94) 206 Final (May 1994).

¹¹¹ See European Commission Report: Taxation in the European Union – The Development of Tax Systems, COM(96) 546 Final (October 1996). This report presented to the ECOFIN reveals that the Commission initiated an informal discussion with the ECOFIN Ministers in meeting at Verona on 13 April 1996 regarding challenges such as stability of fiscal system and realisation of the single market. The ECOFIN appointed a Group to consider the issues. The Group met four times to examine some of the core issues of tax policy and obtained views of the stakeholders and experts. The Committee on Economic and Monetary Affairs & Industrial Policy of the EU Parliament was also taken into confidence on the developments. See also European Commission Communication: A Package to Tackle Harmful Tax Competition in the European Union, COM(97) 564 Final (November 1997). This document was submitted pursuant to meeting with the ECOFIN in Mandorf-les-Bains on 13 September 1997.

¹¹² Consequent to developments at the meeting and the European Commission Communication, *ibid*, the ECOFIN met again on 1 December 1997 and adopted a Code of Conduct for Business Taxation to tackle the harmful tax competition among Member States, [1998] OJ C 2/2.

¹¹³ The ECOFIN meeting, *ibid* (of 1 December 1997) also approved text of draft Savings Directive and led the Commission to resubmit its draft proposal on Interest-Royalty Directive, above n 35. Accordingly, a proposal for the latter was submitted to the Council (European Commission Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of different Member States, COM(98) 67 Final (March 1998)). The other proposal on Savings

a place in the European tax agenda. These included an introduction of the CCCTB and a vigorous pursuit of removal of double taxation in the single market.¹¹⁴

3 *The Recent Period*

As noted above, the EU, owing to the ‘slow but consistent emergence’ of constitutional powers in the area of direct taxes, entered the twenty-first century with an updated tax agenda – an agenda that hinted towards some of the ‘proto-federal’ character of tax powers. For instance, the Commission’s policy initiative to have a CCCTB for internal market was launched in 2001.¹¹⁵ A decade down the road in 2011, the Commission submitted a formal draft legislation to the Council for adoption of CCCTB rules.¹¹⁶ The proposal includes an EU-wide single set of tax rules for computing, consolidating and sharing the tax bases under the CCCTB for the group of companies opting for it. No doubt the CCCTB proposal has since moved at a glacial pace for want of unanimous consensus. However, the draft CCCTB legislation remains at the top tax agenda and the Commission has recently announced to relaunch a more pragmatic version of the draft towards the end of 2016.¹¹⁷ The anti-tax avoidance drive that has taken an unprecedented momentum in 2016 indeed serves as phase one of the EU plan towards CCCTB legislation.¹¹⁸

In 2011, the European Commission also focused on the bilateral tax treaties network existing between the Member States, highlighting the inadequacy of classical tax treaty regime in abolishing challenges posed by double tax burdens to the free flow of labour and capital in the single market. The Commission held an extensive EU-wide consultation with individuals, professional bodies and businesses on factual cases of double

Directive, after deliberation by the Parliament and then again by the ECOFIN in its meeting of 26–27 November 2000, was resubmitted to the Council (European Commission Proposal for a Council Directive to Ensure Effective Taxation of Savings Income in the Form of Interest Payments within the Community, COM(2001) 400 Final–2001/0164 (CNS) (July 2001). Finally, both legislation were adopted through Interest-Royalty and Savings Directives, above nn 35–36.

¹¹⁴ See, eg, European Commission Communication: Tax Policy for the European Union – Priorities for the Years Ahead, COM(2001) 260 Final (May 2001); European Commission Communication: Towards an Internal Market without Tax Obstacles – A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities, COM(2001) 582 Final (October 2001); on related work, see also European Commission Staff Working Paper: Company Taxation in the Internal Market, SEC(2001) 1681 Final (October 2001). Having regard to the Commission’s initiatives, the EU Parliament also adopted a resolution (Mar. 14, 2002) affirming the priority agenda ahead on tax policy (European Parliament Resolution on the European Commission Communication on Tax Policy in the European Union COM(2001)260, [2003] OJ C 47/E/591–594).

¹¹⁵ European Commission Communication: An Internal Market without Company Tax Obstacles: Achievements, /Ongoing Initiatives and Remaining Challenges, COM(2003) 726 Final (November 2003). On the CCCTB initiative, meetings and documents of its Working Group, see <http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm> (last accessed 26 August 2015).

¹¹⁶ Commission Proposal on CCCTB Directive, above n 26.

¹¹⁷ European Commission press release IP/15/5188: Commission presents Action Plan for Fair and Efficient Corporate Taxation in the EU (17 June 2015), available <http://europa.eu/rapid/press-release_IP-15-5188_en.htm> (last accessed 18 June 2015); see also Commission documents cited in above n 39.

¹¹⁸ On anti-tax avoidance measures, see, eg, above n 38, and accompanying text; see also below n124.

taxation.¹¹⁹ The EU model tax convention or some other multilateral tax treaty apparatus in the single market has long been an area of interest for several European tax law experts.¹²⁰ This is because the supranational governance in the EU has attained a structure akin to a ‘federal-like’ polity. On the contrary, however, the classical bilateral treaty network between the Members, based largely on the OECD Model Tax Convention, does not go beyond traditional *bilateral-market-solutions*, and that too, in limited spheres between two sovereign nations concluded under the public international law. Thus the Commission’s focus on ridding the single market of double tax burdens through some kind of European apparatus beyond the traditional bilateral treaty regime seems consistent with the mobility of EU powers. Furthermore, pursuant to the demise of article 293 of EC Treaty, which urged Members to search for fixes to double taxation problems outside the EU law, one cannot rule out prospects of ‘new European tax powers’ against excessive taxation in the single market.¹²¹ Since the Lisbon Treaty came into effect in 2009, there has been an ongoing debate on a shift in EU tax powers because article 293 of EC Treaty – meant for bilateral negotiation to abolish double taxation – has been repealed.¹²² The Commission’s consultation on how to abolish double taxation in recent years is a fair indication as to a starting point towards prospective EU policy initiatives against double tax burdens in accordance with the expanding legal room in the European constitution.

A more recent focus of the EU on measures concerning anti-Base Erosion and Profit Shifting in the single market has witnessed unprecedented activity surrounding tax legislation. A series of legislative measures, including the adoption of an anti-tax avoidance directive¹²³ together with several other measures amending pre-existing tax directives,¹²⁴ indeed underpin that growth in unspoken European legislative powers, which have gained remarkable momentum in their journey along the evolutionary path.

¹¹⁹ European Commission Communication: Double Taxation in the Single Market, COM(2011) 712 Final (November 2011); see also Directorate-General for Taxation and Customs Union, ‘Commission’s Consultation on Double Taxation Conventions and the Internal Market: Factual Examples of Double Taxation Cases’ (January 2011), available at <http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_04_doubletax_en.htm> (last accessed 26 August 2015).

¹²⁰ See, eg, Pasquale Pistone, *The Impact of Community Law on Tax Treaties – Issues and Solutions* (Kluwer Publishers, 2002); Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* (Tilburg University PhD Dissertation, 2001).

¹²¹ Above n 22 (EC Treaty above n 4, art 293, second indent: ‘Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: ... the abolition of double taxation within the Community’).

¹²² See, eg, Shafi U Khan Niazi and Richard Krever, ‘*Romance and Divorce* between International Law and EU law: Implications for European Competence on Direct Taxes’ (forthcoming) 53 *Stanford Journal of International Law* (arguing that the international law paradigm gradually *alienates* from the EU law and that, in turn, boosts constitutional powers to enact EU-level tax policy); Eric Kemmeren, ‘After repeal of Article 293 EC Treaty under the Lisbon Treaty: the EU objective of eliminating double taxation can be applied more widely’ (2008) 17 *EC Tax Review* 156; Khan Niazi and Krever, above n 74, 462–70.

¹²³ For Anti-Tax Avoidance Directive, see above n 38 and accompanying text.

¹²⁴ On some of the amendments/draft amendments in the pre-existing tax directives that have nexus with anti-BEPS measures, see, eg, (1): *Council Directive 2014/86/EU, amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*, [2014] OJ L 219/40–41; (2) *Council Directive (EU) 2015/2376 amending Directive 2011/16/EU as regards mandatory automatic*

To that end, besides tax legislation at the Council-level, some of the measures initiated by the Commission against abusive tax practices and national tax subsidies are also unparalleled in EU tax history. There is, for example, no earlier precedent in the EU of recent actions against national tax rulings that in view of the Commission amount to illegal tax subsidies extended by Members to certain multinationals. The application of the EU state aid regime to national tax measures, which has resulted in rulings on recovery of huge tax amounts from Apple, Starbucks, and Fiat Finance and Trade,¹²⁵ is already making headlines in the international tax arena. Also, the Commission's scrutiny in other cases of similar character including McDonalds, Amazon and others is ongoing.¹²⁶ While the executive rulings in this 'new-found-land' have yet to undergo judicial review,¹²⁷ this activity nevertheless points to an opening of new doors to ever-evolving EU tax powers.

D Enhanced Referrals to the ECJ

The landscape of EU tax powers remains incomplete without looking into the judicial version on the competence allocation in this policy area. One significant aspect of the judicial context is a remarkable rise in the frequency of ECJ rulings caused by increased tax litigation in recent decades. The Court rulings in direct tax regime have been increasing since the late 1980s and became intensive in the subsequent periods.¹²⁸

exchange of information in the field of taxation, [2015] OJ L 332/1–10; (3) European Commission Proposal for a Directive of the Parliament and the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, COM(2016) 198/2, 2016/0107 (COD) (2016), <http://ec.europa.eu/finance/company-reporting/docs/country-by-country-reporting/160412-proposal_en.pdf> (last accessed 12 April 2016).

¹²⁵ European Commission press release IP/16/2923: State aid: Ireland gave illegal benefits to Apple worth € 13 billion (30 August 2016), available at <http://europa.eu/rapid/press-release_IP-16-2923_en.htm> (last accessed 30 August 2016); European Commission press release IP/15/5880: Commission decides selective advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU State aid rules (21 October 2015), available at <http://europa.eu/rapid/press-release_IP-15-5880_en.htm> (last accessed 30 August 2016).

¹²⁶ See, eg, European Commission press release IP/15/6221: State aid: Commission opens formal investigation into Luxembourg's tax treatment of McDonalds (3 December 2015), available at <http://europa.eu/rapid/press-release_IP-15-6221_en.htm> (last accessed 30 August 2016); European Commission press release IP/14/1105: State aid: Commission investigates transfer pricing arrangements on corporate taxation of Amazon in Luxembourg (7 October 2014), available at <http://europa.eu/rapid/press-release_IP-14-1105_en.htm> (last accessed 30 August 2016); European Commission press release IP/16/3085: State aid: Commission opens in-depth investigations into Luxembourg's tax treatment of GDF Suez (now Engie) (19 September 2016), available at <http://europa.eu/rapid/press-release_IP-16-3085_en.htm> (last accessed 19 September 2016).

¹²⁷ The Commission's tax rulings in the cases of Starbucks, and Fiat Trade and Finance are under appeal; see *Fiat Chrysler Finance Europe v Commission*, T-759/15, appealed on 29 December 2015; *Netherlands v Commission*, T-760/15, appealed on 23 December 2015. Likewise, Ireland has also decided to contest the Apple decision before the court; see <www.finance.gov.ie/news-centre/press-releases/minister-noonan-disagrees-profoundly-commission-apple> (last accessed 1 September 2016).

¹²⁸ About 290 cases of all kinds of direct taxes came before the ECJ until 2014. Just a few of these cases relate to the pre-1990 period, followed by around 40 cases in 1991–2000, while the remaining cases came up before the Court in 2001–2014; see Marcel Schaper, '30 years of Direct tax Litigation before the Court of Justice of the European Union: An Empirical Survey'

Notwithstanding the disputation of ECJ tax case law by a segment of legal scholarship,¹²⁹ the increased litigation in itself explains an ever-expanding space of European tax powers. The rise in number of tax disputes before the ECJ is also suggestive of a progressive shift in the locus of tax competence in the so-called flexible list of items on the menu (Part IV(C)). The following illustrates how a growing array of tax litigation also correlates with a changing notion for EU tax powers.

In its response to the evolutionary phase the single European market passes through and the level of integration it attains, the mobility of accompanying economic and fiscal essentials (ie powers in these areas) become inevitable. In these circumstances, either the Member States have to pre-empt or respond on their own to the integrational imperatives of the increasingly integrated market or, if their inaction (or insufficient action) does not meet the gaps created by inter-Member trade and economic activity, market forces call for an optimal EU intervention. If both national and EU actions are non-existent, or are deficient, the injured parties would tend to enforce their constitutional rights such as free movement of labour and capital by seeking remedies through national courts. The wider the gap, the larger would be the number of cases contested before the courts. With increased lawsuits in the national courts, the probability of referrals to the ECJ would equally increase. The result is obvious – that is, enhanced referrals from national courts seeking preliminary rulings of the ECJ – and this has been precisely the case in recent years.¹³⁰

In addition to moving national courts, demands generated through transnational taxpayers, firms and other non-state, pro-integration lobbyists may also push the European Commission to activate its efforts to settle cross-border tax disputes of firms and individuals.¹³¹ This may again end up in increased litigation in tax matters before the ECJ, since one of the Commission's key activities involves initiation of infringement

(2014) 68 *Bulletin for International Taxation* 236–237 (data of ECJ cases during 1983–2013); see also Directorate-General of Taxation & Customs & Union, *CJEU Cases in the Area of, or of Particular Interest for, Direct Taxation* (2015), <http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/case_law/court_cases_direct_taxation_en.pdf> (last accessed 4 January 2016).

¹²⁹ A segment of legal scholarship is critical of decisions of the ECJ on direct taxation, in particular the Court's robust approach towards achieving non-discriminatory taxation in absence of harmonized tax base and rate, dismantling of long established imputation system on dividend taxation in Europe; see, eg Graetz and Warren, above n 14, 1208–1212; Michael J Graetz and Alvin C Warren, 'Dividend taxation in Europe: When the ECJ makes tax policy' (2007) 44 *Common Market Law Review* 1577–1623; Wolfgang Schön, 'Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?' (2015) 69 *Bulletin for International Taxation* 271–293. However, without going into a discussion on merits of ECJ rulings, the point in question is to emphasize a significant increase in transnational tax litigation in recent decades; see, eg, data in above n 128.

¹³⁰ Unlike the known litigation process worldwide, where aggrieved parties (taxpayers or tax authorities, as the case may be) bring their cases to federal constitutional courts, it is different with the ECJ. The aggrieved parties cannot bring their cases before the ECJ. Rather, there could be two main possibilities behind institution of cases before the ECJ: (1) National courts may refer certain questions arising from interpretation of primary or secondary EU law to seek preliminary ruling of the ECJ (TFEU, above n 4, art 267); (2) The Commission may refer any matter to the ECJ if a Member is considered to have failed to fulfil its obligation under the EU law (TFEU, above n 4, art 258).

¹³¹ In theorising growth in transnationalism causing increased activity at the ECJ and Commission-level, see discussion and literature cited in above n 89.

proceedings against those national tax policies that impede free movement of labour and capital in the single market.¹³² Eventually, the infringement-based activity of the Commission also in several cases ends up in litigation at the level of the ECJ.¹³³

The tax-related litigation, whether initiated through referrals of national courts or triggered by Commission infringement proceedings, is indeed supportive of the reasoning noted above. That is, the internal market, in consequence of growth in transnational economic activity caused by the freedom clauses, increasingly attained a new integrational phase over time. At each phase, the locus of the derivative EU (tax) power that otherwise is submerged in the freedom clauses and the single market notion migrates to a new position.

To that effect, if this argument – even in part – qualifies to explain the increased frequency of litigation before the ECJ in the field of direct taxes, it may then reasonably uphold the thesis of growing implicit EU legislative powers in the tax realm over time. Thus the EU power to formulate Union-wide policy for integration of direct taxes could be argued to have inevitably gained width and breadth relative to the founding times – and, on the same rationale, is likely to grow and expand further in times ahead.

V CONCLUSION

The EU law does not explicitly empower the Union to formulate policy in the area of direct taxes – an area left generally to Member States. Nevertheless, if national (tax) laws infringe the single market principles, the EU could intervene. This study dissected the constitutional notion of the internal market to explore the emergence of implied European powers on direct taxes developing in the undergrowth of freedom clauses. A unique feature of multilevel governance is that the Union-Members power equilibrium is of dynamic character and changes over time in accordance with the level of integration attained by the single market at a given point in time. The freedom clauses cultivate the seeds of transnational economic activity through free movement of labour, capital, goods, and services in the single market. Alongside the growth of these freedoms, economic activity across the European market also grows and, consequently, so do the meanings of EU powers in those policy areas which are incidental to that market including the (implicit) tax powers. This article suggests that pursuant to freedom clauses, the transnational economic activity has grown – and may grow further – to attain level(s) where adequate EU-level actions become increasingly inevitable in the tax policy sector. The result is an ever-mobile (implicit) supranational EU competence to address double tax burdens, tax-induced distortions and tax avoidance issues that impede the functioning of single European market. The analysis offered here, therefore, concludes that the policy

¹³² TFEU, above n 4, art 258.

¹³³ In fact, about 56 direct tax cases decided by the ECJ until 2001 originated from the Commission; out of these, more than 90 percent (around 52) cases have been initiated by the Commission against Members for breach of EU (direct tax) law just since 2002; see Shaper, above n 128. Besides, a large number of infringement cases do not undergo litigation since Members mostly comply with the infringement notices of the Commission and remove inconsistencies in their national tax measures. For example, during the period 2000–13, almost 700 cases of infringement proceedings initiated by the Commission against income tax measures of Members were settled out of court. (Commission's letter of 29 January 2015 (personal communication; letter on file with author.)

of limited intervention to formulate EU-level rules in the field of direct taxes may not persist in the long run, but rather may shift to wider and deeper European tax measures in times ahead.

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A REVIEW OF RESEARCH ON CORPORATE TAX AGGRESSIVENESS AND THE LEVERAGE PUZZLE

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ABSTRACT

This article reviews previous research on the relationship between corporate tax aggressiveness and leverage and shows that the puzzle remains unsolved. Mixed findings are reported in prior literature. Four main propositions from previous studies to explain this relationship are discussed in this paper: debt interest deductibility; non-debt tax shields; debtholders' concerns about managerial rent extraction; and uncertainty about the future cash flows of tax avoiders. This review paper suggests four main factors to account for the inconsistent results in past empirical studies: the causal or bi-directional relationship between tax aggressiveness and debt; proxies for tax aggressiveness; measures of firm leverage; and the endogeneity of corporate tax status. Suggestions are provided for future research on the tax aggressiveness and leverage puzzle with a view to reconciling the mixed findings in the existing literature.

* Keywords for this article: corporate taxation, tax aggressiveness, tax planning, leverage, cost of debt. The author may be contacted at jonathan.nguyen@student.unsw.edu.au.

I INTRODUCTION: THE PUZZLE OF CORPORATE TAX STATUS AND LEVERAGE

Researchers have long raised questions surrounding the relationship between corporate taxes and debt levels in companies' capital structure. The literature in tax, accounting and finance fields in the last four decades has proposed different theories and performed various empirical tests on this relationship. Since the early optimal capital structure theory put forward by Miller in 1977 and DeAngelo and Masulis in 1980, academics across those fields have consistently reported mixed results on the association between firms' tax aggressiveness and their leverage.¹

Myers stated in 1984, 'I know of no study clearly demonstrating that a firm's tax status has predictable, material effects on its debt policy'.² Nearly two decades later, Gordon and Lee, in their 2001 study of the impact of taxes on corporate debt policy, remark that 'economists have had great difficulty providing evidence that taxes in fact affect debt/asset ratios'.³ Since then, academics in this area have provided some significant results regarding the association between company tax status and firm's leverage (or cost of debt); however, the reported findings are mixed when it comes to the sign (ie positive or negative) and direction (ie causation) of this relationship.

Indeed, while many studies find a positive relation between tax avoidance strategies and debt holdings by firms supporting the argument that companies employ high debt structure for tax planning purposes due to the tax-deductible nature of interest expenses, a number of other papers report that corporate tax aggressiveness is negatively associated with both leverage and cost of debt; they attribute this result to the non-debt tax shields utilised by tax sheltering firms rather than tax strategies which favour high interest deductions on borrowings.

On one hand, Graham observes an 'under-leverage puzzle' phenomenon where firms' leverage level is noticeably lower than expected when they are of large size and operate with good financial performance and liquidity.⁴ Researchers, in an attempt to explain this 'under-leverage' phenomenon, propose that tax shelters act as non-debt tax shields which substitute for the use of debt and interest deductions to companies.⁵

On the other hand, an 'under-sheltering puzzle' is observed by Weisbach, who notes that some firms do not engage in tax sheltering as much as they might, given the low expected costs associated with tax avoidance for those firms.⁶ Desai and Dharmapala suggest that the explanation for this 'under-sheltering' phenomenon is

¹ Merton H Miller, 'Debt and Taxes' (1977) 32(2) *Journal of Finance* 261; Harry DeAngelo and Ronald W Masulis, 'Optimal Capital Structure under Corporate and Personal Taxation' (1980) 8 *Journal of Financial Economics* 3.

² Stewart C Myers, 'The Capital Structure Puzzle' (1984) 39(3) *Journal of Finance* 575.

³ Roger H Gordon and Young Lee, 'Do Taxes Affect Corporate Debt Policy? Evidence from U.S. Corporate Tax Return Data' (2001) 82(2) *Journal of Public Economics* 195.

⁴ John R Graham, 'How Big Are the Tax Benefits of Debt?' (2000) 55(5) *Journal of Finance* 1901.

⁵ John R Graham and Alan Tucker, 'Tax Shelters and Corporate Policy' (2006) 81(3) *Journal of Financial Economics* 563.

⁶ David A Weisbach, 'Ten Truths about Tax Shelters' (2002) 55(2) *Tax Law Review* 215.

that company shareholders tend to have concerns about managers' rent diversion, which might be concealed under opaque reporting for purposes of tax avoidance.⁷ However, many questions remain unanswered – not only in relation to under-leverage but also concerning under-sheltering. These require further examination.

Recognising this uncertainty makes it less surprising that the interaction between company tax-aggressive schemes and firm's leverage (or capital structure) remains a large puzzle. The corporate tax aggressiveness–leverage relationship is rather complicated when taking into account different sources of impacts on this relationship. Among these sources are tax deductibility of interest paid on debts (Miller); non-debt tax shields (DeAngelo and Masulis); agency costs (Crocker and Slemrod); bankruptcy costs (Bartholdy & Mateus); firm size (Stickney and McGee); and capital intensity and research and development activities (Gupta and Newberry).⁸ The empirical findings have thus been inconclusive about the relationship between tax-aggressive activities and cost of debt. This paper reviews the conflicting results reported in previous research and discusses the arguments and theories established in support of those results.

This article proceeds as follows. Part II documents studies that report positive, negative or insignificant association between corporate tax aggressiveness and debt holdings. Part III reviews the rationale underlying these empirical results, prominently the tax deductibility of debt interest, the non-debt tax shield substitution effects and tax exhaustion theory, the debtholders' concerns about managerial rent extraction, and the uncertainty about company's future cash flows. In Part IV, issues in the empirical tests will be examined, including the perception of the causal relationship between tax aggressiveness and company leverage, the differences in proxies used in previous studies, and the endogeneity concern in measuring corporate tax rates. Part V provides suggestions for potential research in this area in the future.

II REPORTED RELATIONSHIP BETWEEN CORPORATE TAX AGGRESSIVENESS AND LEVERAGE

A Studies Reporting Positive Association Between Tax Aggressiveness and Debt Holdings

This section presents previous research that documents a positive relation between tax-aggressive activities and debt levels in corporations.

⁷ Mihir Desai and Dhammika Dharmapala, 'Corporate Tax Avoidance and High-powered Incentives' (2006) 79(1) *Journal of Financial Economics* 145.

⁸ Miller, above n 1; DeAngelo and Masulis, above n 1; Keith J Crocker and Joel Slemrod, 'Corporate Tax Evasion with Agency Costs' (2005) 89(9–10) *Journal of Public Economics* 1593; Jan Bartholdy and Cesario Mateus, 'Debt and Taxes for Private Firms' (2011) 20(3) *International Review of Financial Analysis* 177; Clyde P Stickney and Victor E McGee, 'Effective Corporate Tax Rates: The Effect of Size, Capital, Intensity, Leverage, and Other Factors' (1982) 1(2) *Journal of Accounting and Public Policy* 125; Sanjay Gupta and Kaye Newberry, 'Determinants of the Variability in Corporate Effective Tax Rates: Evidence from Longitudinal Data' (1997) 16(1) *Journal of Accounting and Public Policy* 1.

First, Stickney and McGee, in their research on corporate effective tax rates (ETRs) of US firms in three years from 1978 to 1980, report – among other findings about characteristics of tax-aggressive firms – corporations that have low ETR are likely to have high debt levels in their capital structure.⁹ One of the limitations of that research, as recognised by the authors, is that the analysis does not take into the account the tax benefits from unused tax shields that are not in debt form such as tax loss carry-forward provisions. It is possible that other non-debt tax shields could have an impact on the reported association between tax avoidance and leverage.

In the same vein, Mills, Erickson and Maydew find evidence supporting the increase in debt use in tax-aggressive firms reported by Stickney and McGee.¹⁰ Mills et al use tax planning cost data obtained from confidential surveys previously collected by Slemrod and Blumenthal to conduct research on investments in tax planning by US corporations.¹¹ Mills et al report results showing that ETR is negatively associated not only with tax planning costs but also with leverage.¹² A high ETR suggests that a company has good tax compliance status, and the corollary is also true: low ETR indicates that the firm has successfully adopted a tax planning strategy to lower their tax liabilities. In other words, the findings by Mills et al demonstrate that leverage is significantly and positively related to tax aggressiveness.

Dyrenge, Hanlon and Maydew conducted a study of long-run tax avoidance for US firms over a ten-year period (1995–2004) and reported that their sample's group of long-run tax avoiders (ie paying low taxes) on average employs more debts than the group of tax-compliant firms (ie paying high taxes).¹³ The usefulness of this research lies in its ability to capture successful tax avoiding firms in the long run; 26 per cent of the companies in the sample kept their cash ETR below 20 per cent for the ten-year period and 9 per cent of the sample firms' cash ETRs were below 10 per cent, compared with the mean tax rate of 30 per cent for the sample. This suggests that the finding of a positive association between debt holdings and tax avoidance here reflects the debt structure of those firms that are committed to long-term sheltering strategies rather than merely having ETRs decreased in one year for some special (and likely legitimate) reasons.

Similarly Seidman, studying the difference in book income and taxable income (book–tax difference, or BTD) reported by US corporations between 1993 and 2004, produces regression results showing that BTD is positively related to cost of debt, consistent with the discussion on off-balance sheet financing by Mills and Newberry.¹⁴ When used as a proxy for company tax sheltering, higher BTD implies

⁹ Stickney and McGee, above n 8.

¹⁰ Lillian F Mills, Merle M Erickson and Edward L Maydew, 'Investments in Tax Planning' (1998) 20(1) *Journal of American Taxation Association* 1; Stickney and McGee, above n 8.

¹¹ Joel Slemrod and Marsha Blumenthal, 'The Income Tax Compliance Cost of Big Business' (1996) 24(4) *Public Finance Quarterly* 411; Mills, Erickson and Maydew, above n 10.

¹² Mills, Erickson and Maydew, above n 10.

¹³ Scott D Dyrenge, Michelle Hanlon and Edward L Maydew, 'Long-run Corporate Tax Avoidance' (2008) 83(1) *Accounting Review* 61.

¹⁴ Jeri K Seidman, 'Interpreting the Book-Tax Income Gap as Earnings Management or Tax Sheltering' (2010), *McCombs Research Paper Series* No. ACC-02-10, McCombs School of Business, The University of Texas at Austin, March; Lillian F Mills and Kaye J Newberry,

a more highly tax-aggressive position taken by the firm. In Seidman's paper, the author notes that their BTM measure may only be considered a good proxy for corporate tax avoidance once the impacts of Generally Accepted Accounting Principles (GAAP) changes have been controlled for.¹⁵ Thus, the positive relation between tax-aggressive status and leverage in Seidman's research is not as strong as the evidence provided in Dyreng et al.¹⁶

A US study conducted over a longer period (25 years, from 1982 to 2006) by Dhaliwal, Lee and Pincus finds that BTM is positively associated with cost of capital.¹⁷ Also studying US companies for a 25-year period (1985–2009), Hasan et al test the relationship between tax avoidance by corporations and cost of debt by examining loans from banks to businesses.¹⁸ In that study, evidence was produced to support the positive relation between tax sheltering and cost of bank loans.¹⁹ The result set out in Hasan et al remains robust when accounting for the impacts after the public becomes aware of a firm's involvement in tax avoidance schemes.²⁰ Further, not only are higher spreads of bank loans reported for tax-aggressive companies, but higher spreads in issuing public bonds as well as stricter collateral and covenant terms imposed on bank loans are also found in those firms.²¹ It is noted that the study by Hasan et al has focused on only bank loans and public bonds; however, these two sources do not fully represent the financial liabilities of companies. Nonetheless, as Welch points out, empirical studies of leverage and capital structure should concern not only financial liabilities but also non-financial liabilities, which could affect the overall implication about cost of debt for businesses.²²

In addition, Shevlin, Urcan and Vasvari examine the effects of tax aggressiveness on cost of debt from the perspective of debtholders, whose only way to assess their potential lending decisions is from the publicly available information.²³ Using a sample of company bonds issued in the US between 1990 and 2007, Shevlin et al find that firms' tax avoidance activities are significantly positively associated with corporate bond yields.²⁴ Further tests performed by the researchers show that the

'Firms' Off-Balance Sheet and Hybrid Debt Financing: Evidence from Their Book-Tax Reporting Differences' (2005) 43(2) *Journal of Accounting Research* 251.

¹⁵ Seidman, above n 14.

¹⁶ Seidman, above n 14; Dyreng, Hanlon and Maydew, above n 13.

¹⁷ Dan S Dhaliwal, Hye Seung G Lee and Morton Pincus, 'Book-Tax Differences, Uncertainty about Information Quality, and Cost of Capital' (Working Paper, University of Arizona, July 2009).

¹⁸ Iftekhar Hasan, Chun Hoi, Qiang Wu and Hao Zhang, 'Beauty Is in the Eye of the Beholder: The Effect of Corporate Tax Avoidance on the Cost of Bank Loans' (2014) 113(1) *Journal of Financial Economics* 109.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² Ivo Welch, 'Two Common Problems in Capital Structure Research: The Financial-Debt-To-Asset Ratio and Issuing Activity Versus Leverage Charges' (2011) 11(1) *International Review of Finance* 1.

²³ Terry Shevlin, Oktay Urcan and Florin Vasvari, 'Corporate Tax Avoidance and Public Debt Costs' (Working Paper, University of California, Irvine, August 2013).

²⁴ Ibid.

uncertainty of future cash flows is the main mechanism through which tax aggressiveness increases the bond offering rates.²⁵ Interestingly, although no private information is made available to public bondholders, information quality is found to not play a significant role in the positive association between tax sheltering and bond yields.²⁶

Moving outside the US setting, some Australian empirical works also produce results supporting the positive tax aggressiveness–leverage relationship. Richardson, Taylor and Lanis, in a study of 203 companies listed on the Australian Stock Exchange (ASX), document a significant positive impact of leverage on tax aggressiveness in their regression tests.²⁷ Their main finding is that tax avoidance by a business is positively associated with financial distress.²⁸ A possible explanation, taking into account the higher leverage characteristic of tax-aggressive firms, is that the high debt levels employed by those firms have induced their financial distress. The authors note that one of the limitations of their research is the possibility of omitted variables in the regression model, and suggest there is potential to incorporate the impacts of tax authorities in the tax avoidance model in future studies.²⁹

A few other Australian studies have also shown that tax aggressiveness is positively related to debt levels, although exploration of capital structure is not the overarching aim of these studies. Among those is the research by Richardson and Lanis, which examines the determinants of variability in ETR of Australian firms in the context of the Ralph Review of tax reform in 1999 in Australia.³⁰ The researchers find that leverage is negatively associated with ETRs – that is, leverage increases with the level of tax-aggressive planning by firms.³¹ In addition, the authors contend that following the Ralph tax reform, the ETRs are increased for highly leveraged Australian firms, and argue that the reason for such increase in ETRs is the reduction in tax benefits from interest payments on debts.³²

Analogously, in a later study of corporate social responsibility and tax avoidance in the Australian setting, Lanis and Richardson also obtain a result of a negative and significant relation between leverage level and ETRs – that is, companies that pay less tax have higher level of debts on their balance sheet.³³ This finding once again gives support to the suggested positive tax–debt relationship. Richardson, Taylor

²⁵ Ibid.

²⁶ Ibid.

²⁷ Grant Richardson, Grantley Taylor and Roman Lanis, 'The Impact of Financial Distress on Corporate Tax Avoidance Spanning the Global Financial Crisis: Evidence from Australia' (2015) 44 *Economic Modelling* 44.

²⁸ Ibid.

²⁹ Ibid.

³⁰ Grant Richardson and Roman Lanis, 'Determinants of the Variability in Corporate Effective Tax Rates and Tax Reform: Evidence from Australia' (2007) 26(6) *Journal of Accounting and Public Policy* 689.

³¹ Ibid.

³² Ibid.

³³ Roman Lanis and Grant Richardson, 'Corporate Social Responsibility and Tax Aggressiveness: An Empirical Analysis' (2012) 31(1) *Journal of Accounting and Public Policy* 86.

and Lanis, in their 2013 article, include leverage as one of the independent variables in their tax avoidance model, and report that leverage is positively related to the tax aggressiveness measure for Australian businesses.³⁴ In that study, of the 30 firms identified as having tax disputes with the Australian Taxation Office (ATO), utilising 'deductibility of interest expenses' is the second most common type of tax strategy, behind only schemes involving 'corporate restructuring'.³⁵

A similar result is reported in an empirical study by Taylor and Richardson which examines the incentives for Australian corporations to engage tax planning schemes from a sample of 200 Australian publicly listed firms for the period 2006–2010.³⁶ This research yields regression results showing the positive effects of leverage on tax-avoidance activities.³⁷

Nonetheless, and similar to the US literature, the Australian studies documented here are not without conflict with regard to the relationship between corporate tax aggressiveness and debt holdings. The studies that produce regression coefficients to reject the positive tax aggressiveness–leverage association are reported in (B) and (C) below.

B Studies Reporting Negative Association Between Tax Aggressiveness and Debt Holdings

This section reviews previous studies that find tax aggressiveness to be negatively associated with debt levels or with cost of debt, as opposed to the positive relationship discussed in (A) above.

First, in a study of the relationship between debt and the corporate marginal tax rate, Graham performs regression analysis on 10,000 US companies for a 13-year period, from 1980 to 1992, and simulates those firm's marginal tax rates (MTRs), taking into consideration net operating losses, investment tax credits and alternative minimum tax.³⁸ Graham's research finds evidence that firms with lower tax rates use less debt in their capital structure than firms with higher tax rates.³⁹ Since companies that have an effective marginal tax rate lower than the statutory rate are often considered successful tax planners, Graham suggests that tax aggressiveness is negatively associated with firm leverage. Nonetheless, the low R-squared of the regression means that his analysis cannot convincingly explain the larger portion of leverage decisions by corporations.⁴⁰

³⁴ Grant Richardson, Grantley Taylor and Roman Lanis, 'The Impact of Board of Director Oversight Characteristics on Corporate Tax Aggressiveness: An Empirical Analysis' (2013) 32(3) *Journal of Accounting and Public Policy* 68.

³⁵ Ibid.

³⁶ Grantley Taylor and Grant Richardson, 'Incentives for Corporate Tax Planning and Reporting: Empirical Evidence from Australia' (2014) 10(1) *Journal of Contemporary Accounting & Economics* 1.

³⁷ Ibid.

³⁸ John R Graham, 'Debt and Marginal Tax Rate' (1996) 41(1) *Journal of Financial Economics* 41.

³⁹ Ibid.

⁴⁰ Ibid.

Looking at the same period (1981–1992), Graham, Lemmon and Schallheim study debt and leases used by US firms and report that low tax rate firms are likely to have lower debt levels, supporting the negative relation between tax avoidance and debt.⁴¹ At the same time, Graham et al find an increase in use of operating leases in companies with lower MTR, but find no clear evidence of an association between capital leases and MTR.⁴² Apart from contributing evidence of the negative relationship between tax aggressiveness and debt, that article also demonstrates the different properties of debt and leases in terms of their impacts on corporate taxes.

In another US study, Gordon and Lee document similar result from their empirical tests on US companies for 37 years between 1954 and 1995 (excluding 1962 and 1966–1969) – a much longer period than the studies by Graham in 1996 and Graham et al in 1998.⁴³ That research, using US tax return data, shows a negative relation between debt financing and tax planning opportunities for companies.⁴⁴ Gordon and Lee also demonstrate that short-term borrowings are more responsive to tax incentives than are long-term borrowings; more specifically, the impact of company tax on the elasticity of short-term debt is found to be approximately triple that for long-term debt.⁴⁵ The authors here recognise that tax consequences are not the only issue considered by companies when changing their capital structure in response to potential tax benefits. Indeed, they argue that non-tax implications also play an important role in leverage decisions of corporations.

In the same research line, in 2008 Graham and Mills studied the differences between simulated MTR based on financial statement information and simulated MTR from the US tax return information, using a sample of firms from 1998 to 2000.⁴⁶ This yielded the result that simulated book MTR performs better than the simulated MTR from tax returns in respect of the ability to explain company's debt ratios. In addition, these authors document a positive association between simulated MTRs and debt ratios, supporting the notion that companies achieving low tax rates tend to use less debt.⁴⁷

In an attempt to explain the under-leverage puzzle in tax-aggressive firms (discussed by Graham in 2000), Graham and Tucker examine large corporate tax shelter cases under actual litigation in the US.⁴⁸ This use of actual tax shelter cases gives the research the advantage of using identified tax-aggressive companies compared with other forms of proxy for tax avoidance such as ETR or BTD employed in other studies. However, the authors also confirm that the limitation of their study, in using such a sample, lies in making inferences from a

⁴¹ John R Graham, Michael L Lemmon and James S Schallheim, 'Debt, Leases, Taxes, and the Endogeneity of Corporate Tax Status' (1998) 53(1) *Journal of Finance* 131.

⁴² Ibid.

⁴³ Gordon and Lee, above n 3; Graham above n 38; Graham, Lemmon and Schallheim above n 41.

⁴⁴ Gordon and Lee, above n 3.

⁴⁵ Ibid.

⁴⁶ John R Graham and Lillian F Mills, 'Using Tax Return Data to Simulate Corporate Marginal Tax Rates' (2008) 46(2–3) *Journal of Accounting and Economics* 366.

⁴⁷ Ibid.

⁴⁸ Graham and Tucker, above n 5; Graham, above n 4.

relatively small sample.⁴⁹ The research finds a reduction of 8 per cent in debt ratios in their sample of tax avoidance firms, suggesting that firms that use tax-aggressive planning as 'non-debt tax shield' tend to have lower debt levels.⁵⁰

Additionally, Wilson reports a negative association between debt holdings and tax aggressiveness for a sample of firms drawn from the data previously collected by Graham and Tucker (2006) and additional tax avoidance cases discovered from press articles from 1975 to 2000.⁵¹ Similar to Graham and Tucker, the generalisability of Wilson's results is not strong, because it does not include corporations whose tax avoidance schemes are not detected by the tax authorities (ie Wilson performs the tests only on a set of tax shelter firms successfully identified).⁵²

Lim, in his study of Korean listed companies for the period 1994–2003, investigates the relation between tax avoidance and cost of debt, and expands the examination to include the effects of shareholder activism on this relationship.⁵³ Computing the tax avoidance measure from book-tax difference, Lim finds a negative relationship between the tax avoidance variable and company's cost of debt.⁵⁴ Further tests in Lim's study indicate that tax aggressiveness is more significantly associated with cost of debt in corporations with a higher level of institutional ownership, and that this negative relationship becomes even more remarkable after 1998 as a result of the Korean corporate governance reforms allowing more powers to be exercised by institutional investors.⁵⁵ Hasan et al, who find the opposite result for US companies (discussed in (A) above) argue that the negative relation between tax avoidance and cost of debt found in Lim's research is due to the fact that tax-aggressive entities rely more heavily on loans than bonds.⁵⁶ However, the evidence supporting this argument is insufficient to be persuasive, because different tax jurisdictions are being considered: Lim (2011) studies Korean companies while Hasan et al (2014) examine US firms.⁵⁷

Another piece of evidence in support of Graham and Tucker's conclusions is found by Lim (2012) in his study of Korean listed firms in a seven-year period (2000–2006).⁵⁸ The author proposes that tax-aggressive activities could offer a partial explanation for the under-leverage puzzle.⁵⁹ The context here was a voluntary reduction in leverage after changes in government laws and companies' ETR in

49 Graham and Tucker, above n 5.

50 Ibid.

51 Ryan J Wilson, 'An Examination of Corporate Tax Shelter Participants' (2009) 84(3) *Accounting Review* 969; Graham and Tucker, above n 5.

52 Wilson, above n 51.

53 Youngdeok D Lim, 'Tax Avoidance, Cost of Debt and Shareholder Activism: Evidence from Korea' (2011) 35(2) *Journal of Banking & Finance* 456.

54 Ibid.

55 Ibid.

56 Hasan et al, above n 18; Lim, above n 53.

57 Ibid.

58 Graham and Tucker, above n 5; Youngdeok D Lim, 'Tax Avoidance and Underleverage Puzzle: Korean Evidence' (2012) 39(3) *Review of Quantitative Finance and Accounting* 333.

59 Lim, above n 58.

Korea decreased from 20.3 per cent in 2000 to 14.6 per cent in 2005.⁶⁰ Lim's 2012 paper has complemented and generalised the finding of Wilson, and the earlier finding of Graham and Tucker, by employing a larger sample for the regression analysis; however, the complementary finding from Lim should also be considered with caution because of the different jurisdictions, which may make a material difference to the analysis.⁶¹

After Lim (2012), a study by Lin, Tong and Tucker offered to resolve the concern about country differences (specifically between US and Korea) by examining US firms for the period from 2006 to 2011.⁶² Lin et al's research extends the results found in Graham and Tucker by reporting the inverse association between tax avoidance and debt levels.⁶³ In documenting the substituting characteristic of corporate tax aggressiveness and debt use, Lin et al provide justification for leverage choice as a result of tax-aggressive planning, but not the converse (where leverage structure is causally linked to tax avoidance). The authors also argue that changes in debt structure are likely to be more costly than a tax avoidance strategy.⁶⁴ If this argument is correct, it is more probable that tax aggressiveness causes impacts on leverage and cost of debt rather than that firms change their leverage policy to serve tax planning purposes. However, this is not necessarily true; anecdotally, some firms do intentionally organise their debt holdings in a manner that assists the overall tax-aggressive strategy of the companies, especially when tax planning involves international tax schemes. Besides, Lin et al highlight the interesting 'sticky debt puzzle' where rigidity is observed in companies that remain their capital structures over a long period, even when profit position and tax planning opportunities have already changed.⁶⁵

In another non-US study, Bartholdy and Mateus use Portugal as a setting for their study of the tax aggressiveness–leverage association in private firms. The authors attribute the choice of Portugal, among 'the least developed countries in the OECD', to the fact that Portuguese companies use predominantly bank financing and Portugal has a relatively small financial market.⁶⁶ Using a sample of 998 Portuguese private firms in the period 1990–2000, this study shows that company tax has a positive impact on the debt structure for private firms (ie company tax aggressiveness increases as debt level becomes lower). Bartholdy and Mateus explain that it is cheaper for small private firms to finance their debts through banks than to access funds in the financial market, due to the asymmetric information disadvantage of small entities.⁶⁷ This aspect of the problem highlights the need to control for firm size when examining the relation between tax planning activities and leverage structure. At the same time, because the focus of this paper is on small private firms, the findings here may not be generalisable to larger listed companies.

⁶⁰ Ibid.

⁶¹ Lim, above n 58; Wilson, above n 51; Graham and Tucker, above n 5.

⁶² Lim, above n 58; Shannon Lin, Naqiong Tong and Alan Tucker, 'Corporate Tax Aggression and Debt' (2014) 40(1) *Journal of Banking and Finance* 227.

⁶³ Lin, Tong and Tucker, above n 63; Graham and Tucker, above n 5.

⁶⁴ Lin, Tong and Tucker, above n 63.

⁶⁵ Ibid.

⁶⁶ Bartholdy and Mateus, above n 8.

⁶⁷ Ibid.

In addition, due to the special features of Portugal as mentioned, the negative tax aggressiveness–leverage association documented by Bartholdy and Mateus should be assessed carefully before relating the findings to other developed economies.⁶⁸ Nonetheless, those researchers suggest that the crucial factor in determining debt levels, apart from the tax consequences, is the availability of collateral, and this suggestion can be incorporated in future studies when modelling taxes and debt structure.⁶⁹

Recognising the difficulties encountered when attempting to measure precisely the tax benefit of debts to companies, Barclay, Heitzman and Smith research the tax aggressiveness–leverage relationship in the real estate industry where, the authors argue, the tax benefit of debts could be computed with less error.⁷⁰ Barclay et al attribute this advantage in measuring debt benefits to the fact that the US industry contains both taxable and non-taxable entities.⁷¹ Results of this research show a corresponding increase of 4.7 per cent in debt ratio when marginal tax rate of an entity changes from 0 per cent (non-taxable) to 35 per cent (taxable).⁷² On that basis, the authors conclude that non-taxable real estate firms in the US use less debt than the taxable real estate firms.⁷³

A naive interpretation of this result might be that there exists a negative association between tax aggressiveness and debt levels if non-tax organisation form is considered as a strategy to avoid paying taxes. However, there are two limitations in this study. First, the results are drawn solely from the real estate industry, which makes it difficult to generalise from them to other industries.⁷⁴ Second, the research by Barclay et al essentially examines the debt structure of two different types of organisations.⁷⁵ For that reason, the findings are hard to interpret because a change from a non-taxable entity (with 0 per cent tax rate) to an organisational type that is taxable (at 35 per cent in this case) is different from a change in tax aggressiveness level (eg where ETR changes from 30 per cent to 35 per cent).⁷⁶

In an Australian setting, Richardson, Lanis and Leung examine Australian-listed firms from 2001 to 2010 and draw the conclusion that tax avoidance is inversely related to leverage, consistent with the debt substitution effect discussed in Graham and Tucker (2006).⁷⁷ An extension from previous literature by Richardson et al (2014) is that their research suggests that outside directors magnify the debt substitution effect.⁷⁸ That finding is in contrast with the positive association

68 Ibid.

69 Ibid.

70 Michael J Barclay, Shane M Heitzman and Clifford W Smith, 'Debt and Taxes: Evidence from The Real Estate Industry' (2013) 20 *Journal of Corporate Finance* 74.

71 Ibid.

72 Ibid.

73 Ibid.

74 Ibid.

75 Ibid.

76 Ibid.

77 Grant Richardson, Roman Lanis, Sidney C Leung, 'Corporate Tax Aggressiveness, Outside Directors, and Debt Policy: An Empirical Analysis' (2014) 25 *Journal of Corporate Finance* 107; Graham and Tucker, above n 5.

78 Richardson, Lanis and Leung, above n 77.

between tax avoidance and leverage for Australian corporations reported in other tax aggressiveness studies (Lanis and Richardson 2012; Richardson, Taylor and Lanis 2013; Taylor and Richardson 2014).⁷⁹ The conflicting results here are worth highlighting when these studies are carried out in the same Australian context and for similar periods. Again we see mixed findings on the relationship between tax-aggressive activities and leverage levels of cost of debt, leaving the tax aggressiveness–leverage puzzle unsolved.

When quantitative research yields conflicting results, meta-analysis may help to locate the common ground in the mixed findings reported in past literature. According to Stanley, meta-regression analysis is an approach used in economic, social and medical sciences to synthesise results from previous literature and ‘can help to explain the wide study-to-study variation found among research findings and offer specific reasons, based on the studies themselves, why the evidence on a certain question may appear contradictory or overly varied’.⁸⁰

Reviewing past empirical studies of debt structure and corporate taxation, Feld, Heckemeyer and Overesch conduct a meta-analysis that synthesises findings from 48 prior studies over 25 years.⁸¹ Their meta-regression shows a negative association between corporate tax aggressiveness and debt ratio, and suggests that a reduction in a company’s MTR lowers the debt level adopted for a firm’s capital structure.⁸² The authors argue that the outcomes of previous research depend on the measure of corporate tax status used, and suggest that using the simulated MTR measure from Graham (1996) may overcome the issue of downward bias encountered in estimating the effects of tax strategies on debt structure.⁸³ Additionally, drawing on their meta-analysis, the authors caution that debt financing of multinational companies is also affected by the tax incentives brought about by profit shifting activities that occur in the international business environment. However, that analysis appears to assume that taxes cause changes in debt structure of a company.⁸⁴ Whether or not the tax aggressiveness–leverage association is a causal relationship remains to be addressed.

The literature review in this section demonstrates that previous research on one hand reports a positive relation between tax avoidance and debt holdings, and on the other hand finds that tax-aggressive activities are inversely related to leverage levels as well as to cost of debt. Moreover, some other papers in this same line of research have presented mixed or insignificant findings, adding to the puzzle observed for the tax aggressiveness–leverage relationship.

⁷⁹ Richardson, Lanis and Leung, above n 77; Lanis and Richardson, above n 33; Richardson, Taylor and Lanis, above n 34; Taylor and Richardson, above n 36.

⁸⁰ T D Stanley, ‘Wheat from Chaff: Meta-Analysis as Quantitative Literature Review’ (2001) 15(3) *Journal of Economic Perspectives* 131.

⁸¹ Lars P Feld, Jost H Heckemeyer and Michael Overesch, ‘Capital Structure Choice and Company Taxation: A Meta-Study’ (2013) 37(8) *Journal of Banking & Finance* 2850.

⁸² Ibid.

⁸³ Feld, Heckemeyer and Overesch, above n 81; Graham, above n 38.

⁸⁴ Feld, Heckemeyer and Overesch, above n 81.

C Studies Reporting Mixed or Insignificant Findings

This section discusses previous studies that reach a conclusion of mixed or insignificant findings in respect of the association between tax avoidance and firms' leverage.

First, Gupta and Newberry document mixed results for this association in their study of companies' ETRs using longitudinal data for the two periods, 1982–1985 and 1987–1990, omitting 1986, when the Tax Reform Act 1986 (TRA86) in the US took effect.⁸⁵ For the first ETR measure, which is calculated by dividing the income tax expense by the book income before interest and tax, these researchers find that ETR is negatively and significantly related to debt ratio for both periods, namely pre-TRA86 and post-TRA86.⁸⁶ In contrast, the results for the second ETR measure, which is the ratio of income tax expense to operating cash flows before interest and tax, show the relation between debt ratio and ETR to be positive and significant for the pre-TRA86 period, but positive and insignificant for the post-TRA86 period.⁸⁷ In discussing this ambiguous finding, the authors suggest that the relationship between capital structure and firm's ETR is sensitive to the denominator used in computation of ETR measure, and that their model of ETRs might be incomplete and may have potential biases from omitted variables.⁸⁸ Thus, the sign of this relationship remains inconclusive after this study.

Next, in a study of US companies for the period 1994–2004, Ayers, Laplante and McGuire examine firms' credit risk and how it is assessed by credit analysts using BTD information.⁸⁹ Since BTD can be a measure not only for earnings quality but also for the tax aggressiveness level of a company, an inverse association between changes in BTD and credit rating changes is insufficient to draw conclusion about the relation between tax sheltering and leverage. The research by Ayers et al attempts to shed light on this by dividing the firms into two categories, 'high tax-planning' firms and 'non tax-planning' firms.⁹⁰ The authors find that for 'non tax planners', large movements in BTD, irrespective of their sign, necessarily result in less favourable rating changes (ie higher cost of debt).⁹¹ On the contrary, for 'high tax-planning' firms, they do not find any significant relation between BTD changes and credit rating changes. On that basis, these researchers suggest that the association between BTD and credit risk is attenuated by tax planning activities.⁹² Nonetheless, it should be noted that in this paper the finding of no significant relationship between changes in BTD and credit rating changes depends on the definition of 'high tax-planning' firms. Ayers et al adopt two measures to identify

⁸⁵ Gupta and Newberry, above n 8.

⁸⁶ Ibid.

⁸⁷ Ibid.

⁸⁸ Ibid.

⁸⁹ Benjamin C Ayers, Stacie Kelley Laplante and Sean T McGuire, 'Credit Ratings and Taxes: The Effects of Book-Tax Differences on Ratings Changes' (2010) 27(2) *Contemporary Accounting Research* 359.

⁹⁰ Ibid.

⁹¹ Ibid.

⁹² Ibid.

high tax planners, the cumulative current ETR and the cumulative cash ETR, both of which are computed over a five-year period.

Besides Ayers et al, Nejadmalayeri and Singh analyse corporate bonds issued by US companies from 1994 to 2006 and report that companies with higher tax rates are likely to have smaller credit spreads, which essentially leads to lower cost-of-bond issues.⁹³ Nejadmalayeri and Singh show evidence that credit spreads, which represent for cost of corporate bonds, decrease when the amount of tax loss carried forward grows larger; in contrast, wider credit spreads (ie higher cost of borrowings) are observed when depreciation tax shields increase.⁹⁴ Additionally, the authors suggest that large unutilised tax shields may give shareholders an incentive to continue to make loan payments and to prevent the company from going bankrupt to enable the firm to access the unutilised tax benefits in the future.⁹⁵ According to Nejadmalayeri and Singh, 'at higher tax rates, equity holders would have a greater incentive to avoid defaulting on short-term debt to preserve larger tax shields'.⁹⁶ Although this argument is understandable, managers need to consider many more important issues when making decisions on whether to wind up the company. It is most likely that equity holders are less concerned about tax shields than about other operating and management considerations when it comes to deciding on liquidation of the company.

Apart from the US, a study of international corporate tax avoidance practices by Taylor and Richardson in 2012 using Australian company data yields insignificant results for most of the tax aggressiveness measures employed in their research.⁹⁷ Taylor and Richardson look at Australian-listed firms over four years, from 2006 to 2009, and their regression results show that the ratio of long-term debt over total assets is positively related to four proxies of tax avoidance, but the associations are insignificant for three out of the four proxies used.⁹⁸ The insignificant result reported by Taylor and Richardson is intriguing when the paper suggests that thin capitalisation is one of the two main drivers of tax aggressiveness (with the other one being transfer pricing).⁹⁹ If firms utilise tax havens in combination with thin capitalisation to obtain significant tax liability reductions, it is expected that those firms would have higher debt levels. Following from this argument, the expected result would be that leverage has a significantly positive association with tax avoidance. However, the insignificant coefficients of leverage documented for three out of the four tax avoidance measures in Taylor and Richardson seem inconclusive about this.¹⁰⁰

⁹³ Ali Nejadmalayeri and Manohar Singh, 'Corporate Taxes, Strategic Default, and The Cost of Debt' (2012) 36(11) *Journal of Banking & Finance* 2900.

⁹⁴ Ibid.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Grantley Taylor and Grant Richardson, 'International Corporate Tax Avoidance Practices: Evidence from Australian Firms' (2012) 47(4) *International Journal of Accounting* 469.

⁹⁸ Ibid.

⁹⁹ Ibid.

¹⁰⁰ Ibid.

The discussion in this section, together with (A) and (B) above, clearly highlights the tax aggressiveness–leverage puzzle in past literature, where mixed findings are documented for the direction of the relationship between tax aggressiveness and leverage (or cost of debt). In Part III, the underlying reasons and explanations used in reporting the puzzle of tax aggressiveness and leverage are discussed in more detail.

III RATIONALE OF UNDERLYING RELATIONSHIPS BETWEEN TAX AGGRESSIVENESS AND LEVERAGE

Previous researchers in carrying out their empirical research also propose different theories to establish the rationale of their results of the relationship between tax-aggressive activities and debt levels, or cost of debt. This Part reviews the four most prominent arguments supporting an association, either negative or positive, between tax sheltering and leverage. The first two propositions relate to the tax benefits from interest deductions and non-debt tax shields, which are conflicting arguments frequently referred to in tax aggressiveness studies examining firms' leverage. The third and fourth propositions are, respectively, the debtholders' concern about rent extraction by managers and the uncertainty about future cash flows. These two propositions are recently stated and put forward by Shevlin, Urcan and Vasvari (2013), although the underlying arguments have appeared in the corporate tax avoidance literature prior to that.¹⁰¹

A Debt Tax Shield and Utilising of Interest Deductions

First, one long-standing proposition, frequently referred to by academics in interpreting the relationship between tax aggressiveness and leverage, is the debt tax shield and the deductibility of interest payments on debt. Stickney and McGee (1982), who document a positive relation between tax aggressiveness and debt holdings, discuss a finding by Tambini which shows that the average after-tax cost of debt capital is around half of the average cost of equity capital.¹⁰² Stickney and McGee argue that the difference between cost of debt and cost of equity is the result of the tax treatment of returns to debt holders and equity holders.¹⁰³ In particular, return to debt holders in the form of interest on debt is deductible to company for tax purposes and hence reduces the net profit upon which tax is calculated using the corporate statutory tax rate. On the other hand, return to shareholders in the form of dividend is generally not a tax deduction in calculating the firm's taxable net profit. Thus, use of debt brings tax benefits to the company because interest payments are tax deductible.

For that reason, researchers who find tax avoidance activities positively related to leverage or cost of debt often attribute that result to the debt tax shield, and propose

¹⁰¹ Shevlin, Urcan and Vasvari, above n 23.

¹⁰² Stickney and McGee, above n 8; Luigi Tambini, 'Financial Policy and The Corporation Income Tax', in A C Harberger and M J Bailey (eds), *The Taxation of Income from Capital* (The Brookings Institution, Washington, 1969) 185.

¹⁰³ Stickney and McGee, above n 8.

that corporations may engage in tax-aggressive schemes surrounding firms' leverage choice in order to make the most use of the debt structure. For instance, Lanis and Richardson argue that 'highly leveraged corporations are expected to use tax-deductible interest payments to promote tax aggressiveness in the corporation'.¹⁰⁴ In a study of thinly capitalised tax avoidance in Australia, Taylor and Richardson also argue that the debt tax shield together with those interest deductions supplies rationale for the positive association between tax avoidance activities and leverage.¹⁰⁵

The problem implicit in this argument is that it contradicts the trade-off theory of capital structure, which suggests that firms with high MTRs should use more debt than firms with low MTRs, because the benefit of interest deductions is greater for high-tax-rate firms.¹⁰⁶ The trade-off theory here implies that tax sheltering, which can effectively be represented by low MTRs, is negatively related to debt financing, contrary to the positive association between tax aggressiveness and leverage predicted by the debt tax shield proposition. Graham and Mills advanced this argument as a reason for the negative relation between tax avoidance and debt holdings found in their research.¹⁰⁷

All this points to the need to take the further step of looking at what happens after firms decide to employ more debts because of the interest tax shields, given their high MTRs. The result would most likely be that average tax rates (also ETRs) will be reduced. The larger the interest deduction becomes, the more the ETR decreases, resulting in a reduction in MTR (ie the tax benefit of interest deduction also reduces). There may therefore be an optimal point at which the tax benefit from interest deduction is not sufficient to justify a firm's increase of leverage, given the potential insolvency risks, which move in the same direction as debt levels.

A further point discussed in Hasan et al (2014) is that tax-aggressive activities can result in higher cost of bank loans, which may in turn reduce the incentive for companies to employ tax-sheltering techniques.¹⁰⁸ Nonetheless, previous research (Stickney and McGee 1982; Lanis and Richardson 2012; Taylor and Richardson 2014) would at this point argue that an increase in cost of debt means there is an incentive to further engage in tax aggressiveness by utilising any tax structure that can take advantage of the tax deductibility of interest paid.¹⁰⁹ It is observed here that although Hasan et al have rigorously documented the impacts of tax avoidance on corporations' cost of bank loans, the questions about the opposite direction of this association (ie whether debt structure impacts on the tax-sheltering decision) remain unsolved.¹¹⁰

¹⁰⁴ Lanis and Richardson, above n 33.

¹⁰⁵ Grantley Taylor and Grant Richardson, 'The Determinants of Thinly Capitalised Tax Avoidance Structures: Evidence from Australian Firms' (2013) 22(1) *Journal of International Accounting, Auditing and Taxation* 12.

¹⁰⁶ Graham and Mills, above n 46.

¹⁰⁷ Ibid.

¹⁰⁸ Hasan et al, above n 18.

¹⁰⁹ Stickney and McGee, above n 8; Lanis and Richardson, above n 33; Taylor and Richardson, above n 36.

¹¹⁰ Hasan et al, above n 18.

B Non-Debt Tax Shields: Debt Substitution and Tax Exhaustion Effects

Apart from research articles that report a positive relation between tax aggressiveness and debt holdings, a number of studies show the opposite: tax avoidance is found to be negatively associated with leverage – hence the tax aggressiveness–leverage puzzle. While the debt tax shield and interest deductibility argument supports the positive relationship of the two variables, another proposition – ‘non-debt tax shields’ – is put forward as rationale to back the findings of a negative association.

Revisiting the research study by DeAngelo and Masulis in 1980, we can see that those authors, 35 years ago, proposed that investment-related tax shields and probability of losing deductibility of debt tax shields are positively related, resulting in firms with high investment-related tax shields using less debt in their capital structure.¹¹¹ According to DeAngelo and Masulis, a ‘non-debt tax shield’ (NDTS) serves as a substitute for tax deductions from debt interest, and every firm has an optimal amount of total tax deductions.¹¹² In studying the ‘debt substitution effect’ suggested by DeAngelo and Masulis, research by MacKie-Mason a decade later showed that this substitution effect is more applicable to companies that are more likely to lose the tax benefits from interest deductions.¹¹³ The effect discussed in MacKie-Mason (1990) is referred to as the ‘tax exhaustion effect’.¹¹⁴

Strong support for both of the debt substitution effect and the tax exhaustion effect can be found in Dhaliwal, Trezevant and Wang (1992).¹¹⁵ In a further note, Dhaliwal et al also demonstrate that the tax shield substitution effect could be dominated by the ‘debt securability effect’, which suggests that a firm’s debt level is positively related to its fixed assets, which can be used as collaterals for borrowings (Scott 1977).¹¹⁶ In a separate study, Trezevant examines the debt substitution effect in a setting where a significant tax law change, introduced by the Economic Recovery Tax Act (ERTA) in the US in 1981, provides support for the debt substitution and tax exhaustion effects after controlling for the debt securability impacts.¹¹⁷

As for the studies by Dhaliwal et al and Trezevant, the reason for the reported negative relationship between tax avoidance and leverage (such as Graham and Tucker 2006; Lim 2011; Lin et al 2014) could be that companies engaging in tax-sheltering activities utilise the available NDTS, which act as substitutes for the debt

¹¹¹ DeAngelo and Masulis, above n 1.

¹¹² Ibid.

¹¹³ DeAngelo and Masulis, above n 1; Jeffrey K MacKie-Mason, ‘Do Taxes Affect Corporate Financing Decisions?’ (1990) 45(5) *Journal of Finance* 1471.

¹¹⁴ MacKie-Mason, above n 113.

¹¹⁵ DeAngelo and Masulis, above n 1; MacKie-Mason, above n 113; Dan Dhaliwal, Robert Trezevant and Shiing-Wu Wang, ‘Taxes, Investment-related Tax Shields and Capital Structure’ (1992) 14(1) *Journal of the American Taxation Association* 1.

¹¹⁶ Dhaliwal, Trezevant and Wang, above n 115; James H Scott, ‘Bankruptcy, Secured Debt, and Optimal Capital Structure’ (1977) 32(1) *Journal of Finance* 1.

¹¹⁷ Robert Trezevant, ‘Debt Financing and Tax Status: Tests of Substitution Effect and The Tax Exhaustion Hypothesis Using Firms’ Responses to The Economic Recovery Act of 1981’ (1992) 47(4) *Journal of Finance* 1557.

interest tax shields.¹¹⁸ The debt substitution effect predicts those corporations will reduce their leverage remarkably once the sufficiency of the NDTs can satisfy their demand for tax savings from aggressive activities.

Schallheim and Wells, in a study focusing on NDTs, propose three reasons why companies may prefer NDTs to debt.¹¹⁹ First, interest payments required for debt servicing make it more costly to engage in debt-related aggressive tax planning than to develop tax strategies using other forms of NDTs.¹²⁰ For that reason, Schallheim and Wells argue that the return per dollar of investment in tax shields sourced from debt is much smaller than the return from NDTs.¹²¹ Second, debt often comes with covenants that can impose high transaction costs, making companies lean towards uses of NDTs rather than debt tax shields.¹²² Third, NDTs often involve exploitation of accounting rules which allow firms to lower taxes without changing the accounting profit figures.¹²³

Apart from those three reasons detailed in Schallheim and Wells' paper, there are other costs associated with utilising debt structure as a tax-aggressive strategy, and those costs are real and significant. Insolvency risk is most likely to increase as debt level goes up. Additionally, highly leveraged structure is often not viewed favourably by debtholders, who may consequently demand higher yields on their lending to compensate for the additional risks. Graham's study in 1996 shows that a company will use less debt financing if it has sufficient amount of NDTs, compared with an identical firm without NDTs.¹²⁴ Once again, the tax exhaustion effect is supported by Graham, who contends that firms experiencing tax exhaustion tend to avoid issuing debt because the interest deductions from debt is 'crowded out' by NDTs.¹²⁵

However, it is possible that different forms of NDTs may have different impacts on leverage. Nejadmalayeri and Singh report that firms with higher depreciation expenses – which are a form of NDTs – are likely to have higher cost of issuing bonds, because such depreciation expenses limit tax benefits from loss carry-forwards and consequently increase cost of debt.¹²⁶ This finding by Nejadmalayeri and Singh suggests loss carry-forwards and depreciation expenses have opposite effects on cost of debt: the former is negatively associated with credit spreads (ie consistent with the debt substitution effect in DeAngelo and Masulis), while the latter is positively associated with cost of borrowings.¹²⁷

¹¹⁸ Dhaliwal, Trezevant and Wang, above n 116; Trezevant, above n 117; Graham and Tucker, above n 5; Lim, above n 53; Lin, Tong and Tucker, above n 63.

¹¹⁹ James Schallheim and Kyle S Wells, 'Debt and Taxes: A New Measure for Non-Debt Tax Shields' (Working Paper, University of Utah, February 2006).

¹²⁰ Ibid.

¹²¹ Ibid.

¹²² Ibid.

¹²³ Ibid.

¹²⁴ Graham, above n 38.

¹²⁵ Ibid.

¹²⁶ Nejadmalayeri and Singh, above n 93.

¹²⁷ Nejadmalayeri and Singh, above n 93; DeAngelo and Masulis, above n 1.

The finding of a positive relation between depreciation expenses and cost of debt is difficult to interpret and appears to be in contrast with the substitution effect of NDTs, which may also exist in the form of depreciation expenses, in accordance with DeAngelo and Masulis (1980) and Dhaliwal et al (1992).¹²⁸ In explaining the results of their research, Nejadmalayeri and Singh argue that the properties of depreciation expenses and tax loss carry-forwards are different, and that any 'tax shields that reduce the efficacy of loss carry provisions should increase the cost of debt'.¹²⁹

Moreover, the magnitude of the debt substitution effect may vary depending on the types of tax sheltering strategies being employed by the firms, according to Lin et al 2014.¹³⁰ In particular, Lin et al show that debt use is more weakly associated with benign tax-aggressive schemes; they argue that tax avoidance strategies must be sufficiently powerful and beneficial to justify a firm's costs of adjustment of their capital structure for tax planning purposes.¹³¹ These researchers argue that the substitution effect is evident in companies that are more heavily involved in tax sheltering, but that this effect is reduced in more benign forms of tax aggressiveness and during financial crisis time.¹³²

Therefore, although previous research that documents a negative relationship between tax aggressiveness and leverage often attributes this result to the NDTs and debt substitution effect (Graham and Tucker 2006; Lim 2011; Richardson et al 2014), there are still questions surrounding this proposition.¹³³ First, we are still unsure about whether the substitution effect varies for different forms of NDTs.¹³⁴ Second, more research is required to ascertain whether different types and degrees of tax avoidance strategies result in different magnitudes of debt substitution effect, as proposed by Lin et al.¹³⁵

C *Debtholders' Concerns About Managerial Rent Extraction*

Shevlin et al, in their study of corporate bonds issued by US firms, report that corporate tax avoidance is positively associated with bond yields.¹³⁶ These authors offer an explanation related to the possibility of wealth expropriation by managers.¹³⁷ They theorise that debtholders have concerns about potential rent extraction activities by managers, since those activities can be performed through obfuscated reporting for purposes of concealing tax sheltering from the tax authorities, as suggested by Desai and Dharmapala.¹³⁸ In respect of these concerns, they suggest that debtholders view large blockholders negatively because they not only have incentive to expropriate resources and tax-aggressive activities but are

¹²⁸ DeAngelo and Masulis, above n 1; Dhaliwal, Trezevant and Wang, above n 116.

¹²⁹ Nejadmalayeri and Singh, above n 93.

¹³⁰ Lin, Tong and Tucker, above n 63.

¹³¹ Ibid.

¹³² Ibid.

¹³³ Graham and Tucker, above n 5; Lim, above n 53; Richardson, Lanis and Leung, above n 89.

¹³⁴ Nejadmalayeri and Singh, above n 93.

¹³⁵ Lin, Tong and Tucker, above n 63.

¹³⁶ Shevlin, Urcan and Vasvari, above n 23.

¹³⁷ Ibid.

¹³⁸ Shevlin, Urcan and Vasvari, above n 23; Desai and Dharmapala, above n 7.

also capable of making it happen.¹³⁹ The debtholders' concerns about managers' rent extraction lead to demand by debtholders for higher return from lending to corporations that engage in tax avoidance.

The 'debtholders' concerns' argument is developed from Desai and Dharmapala's contention that managers may employ opaque financial reporting to facilitate the tax-aggressive activities of the firm.¹⁴⁰ In addition, Desai, Dyck and Zingales suggest that the design of the corporate tax system has certain impacts on the private rent diversion carried out by the company's managers, and that reduction of such diversion activity is the common goal of tax authorities and shareholders.¹⁴¹

However, managerial rent diversion is also argued to be a significant concern to debtholders, especially to holders of public debts who only have access to publicly available information – as opposed to banks or credit rating agencies who can obtain privileged information.¹⁴² This concern appears to be well-founded, because it has been documented by Frank, Lynch and Rego that aggressive tax reporting is accompanied by aggressiveness in financial (book) reporting.¹⁴³ Debtholders' concern about managers' rent extraction becomes more pronounced in firms heavily involved in tax sheltering schemes.

Therefore, besides the proposition of interest deductibility from debt tax shields discussed in Part III(A), managerial rent-diverting activities provide another rationale to support the positive relationship between tax aggressiveness and cost of debt. However, this argument has not taken into account the benefits from tax avoidance activities which can be viewed favourably by debtholders. It is possible that lenders evaluate tax-aggressive schemes as projects that effectively reduce tax liabilities and consequently increase cash flows and net profit position. That favourable view by debtholders may counter their concerns about potential resource expropriation by managers. For that reason, it is possible that the result of increased cost of debt for tax avoiders documented in Shevlin et al reflects that the debtholders' concerns about managerial rent extraction is stronger than their favourable view of cash savings from tax aggressiveness, rather than merely reflecting the additional risk from managers' rent diversion which induce an increase in cost of borrowings.¹⁴⁴

D Uncertainty About Future Cash Flows

Besides the 'debtholders' concerns' argument, Shevlin et al also attribute their finding of a positive relation between tax sheltering and cost of public debt to uncertainty about the firm's future cash flows.¹⁴⁵ The authors argue that tax avoidance leads to lower cash flow levels and higher cash flow volatility in the

¹³⁹ Shevlin, Urcan and Vasvari, above n 23.

¹⁴⁰ Desai and Dharmapala, above n 7.

¹⁴¹ Mihir Desai, Alexander Dyck and Luigi Zingales, 'Theft and Taxes' (2007) 84(3) *Journal of Financial Economics* 591.

¹⁴² Shevlin, Urcan and Vasvari, above n 23.

¹⁴³ Mary M Frank, Luann J Lynch and Sonjae O Rego, 'Tax Reporting Aggressiveness and Its Relation to Aggressive Financial Reporting' (2009) 84(2) *Accounting Review* 467.

¹⁴⁴ Shevlin, Urcan and Vasvari, above n 23.

¹⁴⁵ Ibid.

future, which make bond investors view corporate tax sheltering negatively.¹⁴⁶ Their research finds empirical evidence to support this argument after examining three mechanisms through which tax aggressiveness increases bond yields: future cash flow levels, future cash flow volatility, and information quality.¹⁴⁷

The findings by Shevlin et al highlight the fact that decreased cash flow levels in the future account for one-third of the total effect that tax aggressiveness has on public debt cost, but at the same time report that information quality has a very small impact on the tax aggressiveness–leverage relationship.¹⁴⁸ That is particularly interesting because Balakrishnan, Blouin and Guay find tax avoidance significantly reduces corporate transparency.¹⁴⁹ If Balakrishnan et al are right, then the minor role played by information quality, coupled with the opaque financial reporting found in tax-aggressive corporations (Desai and Dharmapala), might reasonably lead us to expect information quality to play a crucial role in debtholders' negative view about tax avoidance strategies.¹⁵⁰ However, information quality is not found to have a compelling effect in the research by Shevlin et al.¹⁵¹

Similar to concerns about managers' rent extraction, uncertainty about the future cash flows of tax-aggressive companies may be argued to result in debtholders' demands for higher bond yields in order to compensate for the additional risk from lower expected cash flows and for the greater volatility in the firm's liquidity position in the future. However, this argument seems to be in stark contrast with the common notion that debtholders view tax aggressiveness favourably due to the cash savings in tax payments required, which can be economically significant for profitable firms.

For companies in need of cash for research and development and other investment activities, their tax aggressiveness may also be viewed positively by lenders, since these firms are using tax savings to invest in future growth. Hence, although the uncertainty of future cash flows proposed by Shevlin et al is one possible explanation of the positive relation between tax avoidance and cost of debt, the way lenders evaluate corporate tax aggressiveness remains unclear.¹⁵² And the answers might differ from one type of lenders (eg banks) to another (eg public bondholders).

In summary, this article discusses four main propositions advanced by previous researchers to explain the relationship between tax aggressiveness and debt levels (or cost of debt). On the one hand, the proposition concerning interest deductibility from debt tax shields supports the finding of tax avoidance being positively associated with leverage. On the other hand, the NDTs theory, together with the

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ Karthik Balakrishnan, Jennifer L Blouin and Wayner R Guay, 'Does Tax Aggressiveness Reduce Corporate Transparency?' (Working Paper, University of Pennsylvania, September 2014).

¹⁵⁰ Balakrishnan, Blouin and Guay, above n 149; Desai and Dharmapala, above n 7.

¹⁵¹ Shevlin, Urcan and Vasvari, above n 23.

¹⁵² Ibid.

debt substitution and tax exhaustion effects, provides support for the negative relationship between tax aggressiveness and debt holdings.

In addition, the last two propositions – the debtholders' concerns about managerial rent extraction and the uncertainty about firm's future cash flows – explain the positive association between corporate tax avoidance and cost of debt. Nevertheless, interpretation of the results of prior research using those four propositions (and any others) should take account of a number of factors that could impact on the empirical tests conducted. These factors are discussed in Part IV.

IV ISSUES IN EMPIRICAL TESTS

Conflicting findings and analyses such as those already discussed naturally invites questions about the way the empirical tests were conducted. Differences in the way empirical analysis is performed can give rise to variation in the results, as in the case of the tax aggressiveness–leverage puzzle. This Part discusses four main issues in empirical studies of tax avoidance and leverage: the causal or bi-directional relationship between the two variables, the proxies used for tax aggressiveness, the leverage measures employed, and the endogeneity nature of this relationship.

A Causal or Bi-Directional Relationship Between Tax Aggressiveness and Leverage

In empirical tests of the relation between tax avoidance and debt, most studies which directly examine this relationship model leverage as the dependent variable and corporate tax status as the independent variable (Graham 1996; Graham and Tucker 2006; Lim 2011; Bartholdy et al 2011; Lin et al 2014).¹⁵³ However, it is observed that a number of other studies may use tax aggressiveness as the dependent variable, and include leverage as a regressor in their models (Gupta and Newberry 1997; Richardson and Lanis 2007; Seidman 2010; Lanis and Richardson 2012).¹⁵⁴ It is worth noting that the way the regression model is constructed does not necessarily mean that research using such model assumes a causal relationship in which the dependent variable is a result of variation in the regressor of interest.

Many of the prior tax aggressiveness studies seem to view the relationship between corporate tax avoidance and leverage as a causal relationship in which companies' debt policy changes under the impacts of tax-aggressive activities. For instance, Richardson, Lanis and Leung argue that corporate tax aggressiveness and corporate governance mechanism affect debt financing.¹⁵⁵ In the same vein, Feld, Heckemeyer and Overesch, in their mega-analysis, contend that an increase in marginal tax rate, which implies a lower level of tax aggressiveness, causes an increase in debt ratio.¹⁵⁶

However, some other researchers advocate the idea that the relationship between tax avoidance and debt holdings should be bi-directional. Graham and Tucker take

¹⁵³ Graham, above n 38; Graham and Tucker, above n 5; Lim, above n 53; Bartholdy and Mateus, above n 8; Lin, Tong and Tucker, above n 63.

¹⁵⁴ Gupta and Newberry, above n 8; Richardson and Lanis, above n 35; Seidman, above n 16; Lanis and Richardson, above n 30.

¹⁵⁵ Richardson, Lanis and Leung, above n 77.

¹⁵⁶ Feld, Heckemeyer and Overesch, above n 81.

the perspective that it is difficult to prove the direction of this relationship, as in the case of most corporate finance research, and suggest that the coefficients reported in their study should be interpreted as correlation rather than as causality.¹⁵⁷

In addition, Hasan et al suggest that firms with higher cost of debt have incentives to use alternative ways to fund operations and engaging in tax sheltering is one of the alternatives, making it challenging to conclude about the causal inference in research findings.¹⁵⁸ Hasan et al's view is consistent with the contention by Graham and Tucker, supporting the argument that the association between tax-aggressive strategies and leverage should be a two-way, rather than causal, relationship.¹⁵⁹

Quite often higher leverage is interpreted as higher cost of debt; however, this review does not find a convincing argument to infer a relationship between tax aggressiveness and debt levels from a documented association between tax aggressiveness and cost of debt, and vice versa. For instance, Shevlin et al (2013) contend that they find evidence consistent with the debt substitution effect in Graham and Tucker (2006) and Wilson (2009), who produce results of a negative relation between tax sheltering and leverage.¹⁶⁰ The authors advance the explanation that 'tax avoidance makes borrowing more expensive thus incentivizing the firms to have lower leverage'.¹⁶¹ However, this view is not clearly supported by the findings in Shevlin et al's paper, because what the researchers find is only a positive impact that tax sheltering has on bond yields, not a direct negative relationship between tax sheltering and debt levels.¹⁶²

Although the incentive for tax-aggressive firms to reduce borrowings (or bond rates, in the case of public bonds) is a legitimate and highly likely explanation, this argument might have not captured the complete picture of a firm's capital structure, and there are many other important factors that could alter the firm's decision to increase or decrease their debt levels:¹⁶³ cash flows, liquidity position, bankruptcy costs and agency costs will enter this leverage puzzle. It is possible that the high cost of debt found in the research is a result of a heavily leveraged structure, regardless of whether that structure is related to tax avoidance strategies; therefore, companies may not be able to cut down on their committed borrowings in spite of their awareness of the high interest rates on debts, at least in the short or medium term.

Another possibility is that the firm's engagement in tax avoidance involves uses of debt interest deductibility, and hence high debt ratio (or high amount of debt holdings in general) is part of such a tax-aggressive scheme. This makes it challenging to conclude whether the association between tax aggressiveness and

¹⁵⁷ Graham and Tucker, above n 5.

¹⁵⁸ Hasan et al, above n 18.

¹⁵⁹ Hasan et al, above n 18; Graham and Tucker, above n 5.

¹⁶⁰ Shevlin, Urcan and Vasvari, above n 23; Graham and Tucker, above n 5; Wilson, above n 51.

¹⁶¹ Shevlin, Urcan and Vasvari, above n 23.

¹⁶² Ibid.

¹⁶³ Ibid.

leverage (or cost of debt) is a causal relationship. Most likely this relationship is a two-sided correlation, as suggested by Graham and Tucker.¹⁶⁴

B Proxies for Corporate Tax Status

Since tax avoidance is a sensitive issue to corporations and tax-aggressive activities are not directly observable, prior studies use a number of different measures as a proxy for tax avoidance. There is a possibility that previous mixed findings on the association between tax aggressiveness and leverage are due to the proxies employed in tax-aggressiveness research. Some proxies may capture tax aggressiveness in its broad meaning of 'reduction in tax liabilities', whereas the others may represent tax sheltering at the extreme level of aggressiveness.

First, in tax aggressiveness research, a number of academics use book-tax difference (BTD) as their proxy for corporate tax avoidance (Lim 2011; Richardson, Lanis and Leung 2014; Taylor and Richardson 2014; Lin et al 2014 and so on).¹⁶⁵ Taylor and Richardson in their 2013 paper propose that companies that are successful at avoiding taxes are likely to sustain large difference between book income and taxable income.¹⁶⁶ Meanwhile, Frank et al, in studying corporations' aggressiveness in both financial reporting and tax reporting, suggest that BTD may reflect not only tax-aggressive activities but also earnings management.¹⁶⁷

In order to isolate the component of BTD that is attributable to earnings management, Lim uses discretionary accruals from BTD in his study of tax avoidance by Korean firms.¹⁶⁸ The author suggests that firms avoid tax liability by using both permanent and temporary difference components while managing earnings using mostly temporary difference component.¹⁶⁹ An interesting point in the Korean setting of Lim's study is that the taxable income data of Korean companies are disclosed in the notes to their financial statements, and such disclosure avoids errors arising from estimating taxable income from financial reports, which is an important problem encountered in most US studies.¹⁷⁰

Wilson reported in 2009 that BTD is positively associated with tax sheltering cases, suggesting that BTD could be an appropriate proxy for tax aggressiveness.¹⁷¹ If that is the case, the bias produced from studies using BTD, if any, may not be strong enough to impact the overall results in those papers. Furthermore, Seidman, who examines the interpretation of BTD, adjusts the BTD for three factors: changes in the GAAP, macroeconomic conditions, and earnings management.¹⁷² Seidman finds that BTD adjusted for the GAAP changes can provide a better proxy for tax sheltering in most contexts, although the BTD measure, which is not adjusted for any of the

¹⁶⁴ Graham and Tucker, above n 5.

¹⁶⁵ Lim, above n 53; Richardson, Lanis and Leung, above n 77; Taylor and Richardson, above n 36; Lin, Tong and Tucker, above n 63.

¹⁶⁶ Taylor and Richardson, above n 105.

¹⁶⁷ Frank, Lynch and Rego, above n 143.

¹⁶⁸ Lim, above n 53.

¹⁶⁹ Ibid.

¹⁷⁰ Ibid.

¹⁷¹ Wilson, above n 51.

¹⁷² Seidman, above n 14.

three factors, is generally a reasonable proxy for earnings management.¹⁷³ Overall, it is concluded in Seidman's paper that LTD can be a reasonable proxy for tax avoidance, although care is to be taken when the variable of interest of the research is likely to be affected under macroeconomic conditions.¹⁷⁴

Second, some studies explore MTRs as a measure of corporate tax status (Graham 1996; Graham and Mills 2008; Bartholdy and Mateus 2011; Barclay et al 2013).¹⁷⁵ A firm with lower MTR may be interpreted as successful tax avoidance compared with a higher MTR firm. In Graham's paper, MTR is explicitly calculated, using an expanded version of the method by Shevlin (1990), who simulated MTR while also accounting for carry-forward and carry-back tax opportunities.¹⁷⁶ Graham proposes that the true tax rate to reflect the tax benefit of interest deductibility should be an average of the future expected MTRs and should account for the effects of the total amount of interest deduction available.¹⁷⁷

In another study by Graham and Mills, the research shows that the simulated MTR based on financial statements is highly correlated with the MTR simulated from tax return information, which supports the reasonableness of using book-simulated MTR as a proxy of companies' dynamic tax status.¹⁷⁸ Besides, Graham and Mills provide a summary of suggestions of MTR measures to be used for domestic and international studies.¹⁷⁹ However, since MTR mainly reflects future tax benefits, as discussed by Nejadmalayeri and Singh, MTR may not be a good proxy for tax-aggressive strategies, which are associated with past decisions but lead to the existing leverage structure.¹⁸⁰

Third, ETR is probably the most commonly used proxy for corporate tax aggressiveness (Richardson and Lanis 2007; Dyreng et al 2008; Minnick and Noga 2010; Lanis and Richardson 2012; Lin et al 2014 and so on).¹⁸¹ An ETR value that is lower than the corporate statutory tax rate is a strong indicator that the firm engages in at least some tax-aggressive planning. In spite of its frequent use in tax avoidance studies, there is no consensus about how to compute ETR. In calculating the ETR measure, the numerator is often either the income tax expense recorded in the financial report or the cash taxes paid, whereas the denominator is often a choice between the pre-tax book income or the operating cash flows.

¹⁷³ Ibid.

¹⁷⁴ Ibid.

¹⁷⁵ Graham, above n 38; Graham and Mills, above n 46; Bartholdy and Mateus, above n 8; Barclay, Heitzman and Smith, above n 70.

¹⁷⁶ Graham, above n 38; Terry Shevlin, 'Estimating Corporate Marginal Tax Rates With Asymmetric Tax Treatment of Gains and Losses' (1990) 11(1) *Journal of the American Taxation Association* 51.

¹⁷⁷ Graham, above n 38.

¹⁷⁸ Graham and Mills, above n 46.

¹⁷⁹ Ibid.

¹⁸⁰ Nejadmalayeri and Singh, above n 93.

¹⁸¹ Richardson and Lanis, above n 30; Dyreng, Hanlon and Maydew, above n 13; Kristina Minnick and Tracy Noga, 'Do Corporate Governance Characteristics Influence Tax Management' (2010) 16(5) *Journal of Corporate Finance* 703; Lanis and Richardson, above n 33; Lin, Tong and Tucker, above n 63.

In the research by Richardson and Lanis (2007), two ETR measures are employed for their research: the first proxy ETR1 is the income tax expense divided by the pre-tax book income; the second proxy ETR2 is the ratio of income tax expense over the operating cash flows.¹⁸² Hasan et al compute their cash ETR measure as the cash taxes paid divided by the pre-tax book income less special items.¹⁸³

Dyreng et al prefer cash ETR to book ETR, arguing that cash ETR is not affected by accounting rules, whereas cash taxes paid across all jurisdictions can reflect global tax-aggressive activities in multinational firms.¹⁸⁴ In their study, Dyreng et al calculate the long-run cash ETR over a ten-year period (1995–2004) in order to examine long-run corporate tax avoidance.¹⁸⁵ Some other studies, however, use a shorter period (ie average ETR over five years rather than ten years, as do Minnick and Noga) when analysing long-term tax measures.¹⁸⁶ Nevertheless, ETR is often viewed as a rather static proxy, and an important drawback of using ETR lies in the fact that ETR cannot take into account the interaction between tax advantage of debt and the firm's future profitability.¹⁸⁷

Fourth, recent studies in the US take advantage of the Financial Accounting Standards Board Interpretation No. 48 (referred to as FIN 48), which requires US companies to disclose their tax reserve for uncertain tax positions.¹⁸⁸ The amount of tax reserve reported under FIN 48 disclosure requirement is used as a proxy for tax avoidance activities. A larger reserve generally indicates a highly uncertain tax position due to involvement in aggressive tax planning. Lin et al also use FIN 48 tax reserve as one of the proxies for tax aggressiveness in their research, and find significant association between this measure and leverage.¹⁸⁹ The problem with this proxy is that it depends largely on the level of firms' compliance with the FIN 48 requirement. If corporate aggressiveness in financial reporting is indeed positively correlated to tax-aggressive reporting as documented in Frank et al (2009), FIN 48 reserve may not be a reliable measure to capture firms that are aggressive in both tax and financial reporting.¹⁹⁰

Fifth, some researchers use actual tax shelter cases in the form of dummy variable in their tax avoidance studies (Graham and Tucker 2006; Wilson 2009; Hasan et al 2014).¹⁹¹ For instance, Graham and Tucker examine the under-leverage phenomenon in tax-aggressive firms by analysing 44 actual tax shelters, which are used later on by Wilson, who adds to this sample additional tax avoidance cases identified by himself.¹⁹² In another study of the relation between tax avoidance and bank loan cost, Hasan et al perform two quasi-experimental settings, one of which

¹⁸² Richardson and Lanis, above n 30.

¹⁸³ Hasan et al, above n 18.

¹⁸⁴ Dyreng, Hanlon and Maydew, above n 13.

¹⁸⁵ Ibid.

¹⁸⁶ Minnick and Noga, above n 181.

¹⁸⁷ Feld, Heckemeyer and Overesch, above n 81.

¹⁸⁸ See, eg, Hasan et al, above n 18.

¹⁸⁹ Lin, Tong and Tucker, above n 63.

¹⁹⁰ Frank, Lynch and Rego, above n 143.

¹⁹¹ Graham and Tucker, above n 5; Wilson, above n 51; Hasan et al, above n 18.

¹⁹² Graham and Tucker, above n 5; Wilson, above n 51.

uses tax avoidance news announced to the public, while the other uses FIN 48 disclosure.¹⁹³

Like any other measure of tax aggressiveness, utilising actual tax avoidance cases has both advantages and disadvantages. The advantage of this method is that the sheltering schemes are already identified with a high degree of certainty, and thus there is no need to indirectly infer the propensity for sheltering, such as using BTD or ETR. The disadvantages include the small samples used for observations (eg Graham and Tucker 2006; Wilson 2009) and the inability to generalise the results due to the extreme degree of tax avoidance captured in the sheltering cases that are detected, prosecuted and announced to the public.¹⁹⁴ This comes back to the definition of tax aggressiveness, which generally refers to activities that result in tax liability reduction, whereas the tax shelter cases caught under litigation reflect the higher end of the tax-aggressiveness scale.

This section reviews the five proxies of tax aggressiveness frequently used in the accounting and tax literature: BTD-sourced proxy, MTR, ETR, FIN 48 tax reserve, and actual tax avoidance cases. Further, on the topic of measuring tax avoidance, Hanlon and Heitzman provide a comprehensive discussion in their review of prior tax research in accounting.¹⁹⁵

C Measures of Company Debt Levels and Cost of Debt

Not only measures of corporate tax status but also measures of leverage are likely to cause variation in the previously reported mixed findings in the relationship between tax aggressiveness and debt. As mentioned above, while some studies explicitly test debt holding levels (or debt ratios) and the way they are related to tax avoidance, the others examine the tax aggressiveness and leverage puzzle through cost of debt in the tax-aggressive firms. It is observed that prior literature employs a variety of methods to measure debt; therefore, the previous results that may seem prima facie conflicting are indeed not directly comparable.

First, in respect of using debt holdings as a variable representing a firm's debt structure, a number of issues concern researchers in carrying out the empirical tests. These include the forms of debt holding measure used (ie absolute value or ratio), length to maturity (short-term vs long-term), and differences in debtholder types. For example, Bartholdy and Mateus use three debt measures: short-term bank loans, long-term bank loans, and total bank loans, being the sum of the short-term and long-term loans.¹⁹⁶ Lin et al, among others, employ debt variables in the form of ratios, including: debt to assets ratio, long-term-debt to assets ratio, debt over debt-and-equity ratio, and industry-adjusted leverage ratio.¹⁹⁷ In both examples, length to maturity is an explicit concern when the researchers examine the impact of liabilities of both short and long terms on taxes.

¹⁹³ Hasan et al, above n 18.

¹⁹⁴ Graham and Tucker, above n 5; Wilson, above n 51.

¹⁹⁵ Michelle Hanlon and Shane Heitzman, 'A Review of Tax Research' (2010) 50(2-3) *Journal of Accounting and Economics* 127, 139-46.

¹⁹⁶ Bartholdy and Mateus, above n 8.

¹⁹⁷ Lin, Tong and Tucker, above n 63.

In discussing the potential effects of the different maturities on the results, Feld et al argued:

On the one hand, a smaller tax response of long-term debt can be expected because it can hardly adjust to yearly fluctuations in the tax rate. On the other hand, long-term debt is associated with higher interest deductions relative to short-term debt, containing also trade payables that do not carry any interest deductions.¹⁹⁸

Also, according to Feld et al, long-term debt might be more tax-responsive since tax deductions from interest payments are the main tax advantage of debt over equity.¹⁹⁹

Besides, book and market values of the firm are also taken into account in the computation of debt ratio. In the studies by Graham and Tucker (2006) and Richardson et al (2014), leverage is measured in both forms: (a) debt over book value of total assets, and (b) debt over market value of total assets.²⁰⁰ However, in Nejadmalayeri and Singh's paper, the two measures of debt ratio used by the authors are the ratio of total liabilities to market value of equity, and the ratio of long-term debt to total book value of assets.²⁰¹

Further, Graham, in his 1996 study, focuses his examination on incremental financing by testing changes in debts rather than using debt levels as the leverage variable.²⁰² In addition to examining debt levels as well as changes in debt levels, previous literature in this area also tests the relationship between tax avoidance and cost of debt. The measure for cost of debt varies from study to study, depending on the focus of the authors' analysis. While Ayers et al look at credit rating changes, Hasan et al focus on cost of bank loans.²⁰³ Quite different from these two papers, Dhaliwal et al measure cost of capital by averaging the four cost of capital estimates adopted from previous studies (Gebhart et al (2001), Claus and Thomas (2001), Gode and Mohanram (2003), and Easton (2004)).²⁰⁴

In addition, Shevlin et al, in their study of the association between tax avoidance and public debt cost, highlight the differences between the types of debtholders.²⁰⁵ More specifically, these authors pay attention to corporate bond issues and argue that public lenders only have access to publicly available information, not the private

¹⁹⁸ Feld, Heckemeyer and Overesch, above n 81.

¹⁹⁹ Ibid.

²⁰⁰ Graham and Tucker, above n 5; Richardson, Lanis and Leung, above n 77.

²⁰¹ Nejadmalayeri and Singh, above n 93.

²⁰² Graham, above n 38.

²⁰³ Ayers, Laplante and McGuire, above n 89; Hasan et al, above n 18.

²⁰⁴ Dhaliwal, Lee and Pincus, above n 17; William R Gebhardt, Charles M C Lee and Bhaskaran Swaminathan, 'Toward an Implied Cost of Capital' (2001) 39(1) *Journal of Accounting Research* 135; James Claus and Jacob Thomas, 'Equity Premia as Low as Three Percent? Evidence from Analysts' Earnings Forecasts for Domestic and International Markets' (2001) 56(5) *Journal of Finance* 1629; Dan Gode and Partha Mohanram, 'Inferring the Cost of Capital Using the Ohlson-Juettner Model' (2003) 8(4) *Review of Accounting Studies* 399; Peter D Easton, 'PE Ratios, PEG Ratios, and Estimating the Implied Expected Rate of Return on Equity Capital' (2004) 79(1) *The Accounting Review* 73.

²⁰⁵ Shevlin, Urcan and Vasvari, above n 23.

information about the firms that only credit analysts or banks can gain access to.²⁰⁶ Thus, when contrasting the research focus in Shevlin et al against that in Ayers et al, who study the credit ratings imposed by credit analysts, or the focus in Hasan et al, who analyse loan rates determined by banks, it is worth noting that the results in those studies are not directly comparable.²⁰⁷

This section demonstrates that the wide variety of debt measures used in the literature may partly account for the puzzle observed in the relationship between tax aggressiveness and debt. Section (D) discusses the endogeneity issue in studying this relationship.

D Endogeneity of Corporate Tax Status

Another concern of empirical research on the tax aggressiveness and leverage puzzle is the endogeneity of corporate tax status, because it can influence the reliability of the results reported in prior research. The company tax rate is considered endogenous because when a firm increases its debt financing, taxable income is reduced as a result of interest payments, leading to a reduction in MTR. The more highly leveraged a firm is, the more obvious this reduction in MTR becomes.

Graham et al (1998) document evidence showing that company tax rate is endogenous to financing decisions of the firms and that this endogeneity can potentially result in a spurious relation between corporate tax proxies and measures of debt policy.²⁰⁸ In a discussion on this issue, these researchers contend: 'If not properly addressed, this endogeneity of the tax rate can bias an experiment [...] against finding a positive relation between debt and taxes.'²⁰⁹ The authors conclude that the endogeneity problem can have real, substantial impacts on the interpretation of associations with tax variables reported in previous research.²¹⁰ Additionally, the endogeneity issue may affect all forms of tax proxies, including tax variable based on net operating losses or average tax rate (Graham 2003).²¹¹

This endogeneity issue is addressed in Graham et al (1998) by constructing a measure of a company's MTR based on before-financing taxable income in order to take out the interaction between interest expenses and MTR.²¹² Following this approach, Bartholdy and Mateus compute the MTR variable in their research as before financing (ie using net income before interest deductions instead of net taxable profit after interest).²¹³

²⁰⁶ Ibid.

²⁰⁷ Shevlin, Urcan and Vasvari, above n 23; Ayers, Laplante and McGuire, above n 89; Hasan et al, above n 18.

²⁰⁸ Graham, Lemmon and Schallheim, above n 41.

²⁰⁹ Ibid.

²¹⁰ Ibid.

²¹¹ John R Graham, 'Taxes and Corporate Finance: A Review' (2003) 16(4) *Review of Financial Studies* 1075.

²¹² Graham, Lemmon and Schallheim, above n 41.

²¹³ Bartholdy and Mateus, above n 8.

In a review of research on taxes and corporate finance, Graham (2003) suggests lagging the estimated MTR by one period as another method to account for endogeneity issue (following MacKie-Mason), in addition to using before-financing taxable income.²¹⁴ Richardson et al, in their 2013 study, control for endogeneity by lagging independent variables, as opposed to lagging the MTR variable as suggested by Graham.²¹⁵

In another study of corporate taxes and debt, Gordon and Lee (2001) deal with the endogenous nature of corporate tax rate by employing an instrumental variable which uses average profit rate before interest deductions to correct for any potential bias from endogeneity.²¹⁶ In order to directly address the endogeneity concern of corporate tax avoidance, Hasan et al use instrumental variable two-stage regressions.²¹⁷

In summary, researchers can use a number of methods to account for the endogeneity concern in examining tax-related effects. It is emphasised here that addressing the endogeneity problem is necessary when studying the relationship between tax aggressiveness and leverage. Studies of the puzzle of tax avoidance and debt relationship which do not control for endogeneity must therefore be interpreted with caution, as the potential bias arising from endogeneity can be material.

V CONCLUSION AND SUGGESTIONS FOR FUTURE RESEARCH

The relationship between tax aggressiveness and leverage has been a topic of research to academics in tax, accounting and finance in the last four decades, especially after the discussion of debt, taxes and equilibrium in company's capital structure by Miller (1977).²¹⁸ A review of prior literature on this topic shows that the relationship between tax aggressiveness and leverage remains a puzzle in spite of nearly forty years of research.

There appear to be two lines of conflicting conclusions. The first line reports corporate tax avoidance to be positively associated with debt holdings. The explanations include the interest deductibility from debt tax shields, the debtholders' concerns about rent extraction by managers, and the uncertainty about the firm's future cash flows. The second line reports a negative association between tax-aggressive activities and leverage. A number of researchers attribute this finding to NDTs and the documented effects of debt substitution and tax exhaustion. Besides, some other studies show mixed or insignificant findings in respect of the tax aggressiveness–leverage relationship.

The inconsistent results of research on the association between corporate tax avoidance and debt have puzzled researchers in this area. Since several conflicting propositions and arguments have been offered as explanations of the signs and

²¹⁴ Graham, above n 211; MacKie-Mason, above n 113.

²¹⁵ Richardson, Taylor and Lanis, above n 34; Graham, above n 211.

²¹⁶ Gordon and Lee, above n 3.

²¹⁷ Hasan et al, above n 18.

²¹⁸ Miller, above n 1.

directions of the relation between tax aggressiveness and corporate debt policy, a framework is now needed to systematically tease out the factors that drive this relationship.

This review suggests that four main issues, and some minor others, in large part account for the contrary findings in empirical tests: (1) the causal or bi-directional relationship between tax avoidance and debt; (2) the proxies used for firm's engagement in tax-aggressive activities; (3) the measures of debt levels and cost of debt; and (4) the endogeneity of corporate tax status.

A number of issues contributing to the puzzle of tax aggressiveness and leverage require further examination in future research. First, since many competing theories and arguments support negative and positive relations between tax avoidance and debt, it is crucial to determine which proposition is the most relevant, or has the most dominating effect.

Second, although several previous studies have analysed in depth the tax shields arising from debt interest and the NDTs under the debt substitution and tax exhaustion effects, we are still unsure about whether the substitution effect varies for different forms of NDTs (Nejadmalayeri and Singh 2012).²¹⁹ There is a possibility that different types and degrees of tax avoidance strategies result in different magnitude of debt substitution effect, as suggested in the study by Lin et al.²²⁰ Future research can examine the way each type of tax-aggressive scheme (eg debt restructuring, transfer pricing, use of tax havens, etc.) may relate to the debt substitution effect, and subsequently to the firm's decision on its debt structure.

Third, future research may also attempt to document the association between tax avoidance and debt for each level of tax aggressiveness. For instance, a firm which has an average tax rate 5 per cent below the company statutory tax rate can have different properties in respect of debt structure compared with its counterpart, which has successfully achieved an average tax rate 15 per cent or 20 per cent below the statutory rate.

Fourth, it is important to recognise that while debtholders' concerns about managerial rent extraction and uncertain future cash flows are real in firms that are aggressive in both tax reporting and financial reporting, debtholders may at the same time view tax sheltering favourably, due to the tax savings yielded from tax sheltering. There is potential to employ other research methods, perhaps interviews or surveys, to obtain insights about how debtholders view tax avoidance by corporations. Interviews might be conducted with either the bank managers who make decisions about companies' bank loans, or with senior credit analysts. Surveys can potentially help researchers understand how the general public perceives the tax-aggressive activities by companies, and what level of risks (returns) is accepted (demanded). When traditional archival research consistently reports mixed findings, research using qualitative methods or mixed methods can provide opportunities to explore the inconsistency in previous findings and to triangulate the new results.

²¹⁹ Nejadmalayeri and Singh, above n 93.

²²⁰ Lin, Tong and Tucker, above n 63.

Fifth, agency cost in tax is another aspect that may impact the association between tax avoidance and leverage, and CEOs, when making decisions about level of tax aggressiveness as well as the debt structure of firms, will take into consideration not only the real and perceived benefits to shareholders but also their personal interests. Thus, future research can make further inquiries into how CEOs make decisions about tax aggressiveness and leverage structure by using interviews, surveys or a combination of both. As an example, Lavermicocca and McKerchar (2013) previously conducted interviews with tax managers and directors in large Australian companies, followed by surveys, in their study of tax compliance behaviour of large corporations.²²¹ Mixed methodology can meaningfully inform researchers in these areas.

Finally, heavy use of debt is often associated with a company's risk of insolvency, which becomes higher when the economy experiences a financial crisis. Nejadmalayeri and Singh, in their US study of company taxes and cost of debt, observe that during the global financial crisis (GFC) large losses had greater impact on reduction in credit spread (ie lower cost of debt) through tax subsidies.²²² Future studies can potentially provide further insights into the relationship between tax avoidance and leverage by examining this relationship not only during stable macroeconomic environments but also during an economic downturn, with the GFC being a good setting for this experiment.

²²¹ Catriona Lavermicocca and Margaret McKerchar, 'The Impact of Managing Tax Risk on the Tax Compliance Behaviour of Large Australian Companies' (2013) 28(4) *Australian Tax Forum* 707.

²²² Nejadmalayeri and Singh, above n 93.

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