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CONTENTS

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Companies and taxes in the UK: actors, actions, consequences and responses

John Hasseldine, Kevin Holland and Pernill van der Rijt*

Abstract
A growing literature analyses corporate tax planning and avoidance with an emphasis on its economic consequences (Hanlon and Heitzman, 2010). Meanwhile, citing tax gap statistics and subsequently a cause for the Occupy movement, campaigners for social justice in the U.K. and U.S. have used the media to target tax-avoiding firms with protesters taking direct action (e.g. against Vodafone and Bank of America). Policy-makers and tax agencies must calibrate their policy and administrative response to tax avoidance carefully. This paper contributes to our understanding of tax avoidance and related behaviour by drawing on prior literature and international administrative experience in the corporate tax arena. Based on a knowledge management framework, we identify the key actors, their roles and incentives, and outline international practice in terms of co-operative compliance and tax enforcement. We then outline an array of policy responses to tax avoidance including disclosure regimes, anti-avoidance rules and the regulation of intermediaries such as banks and accounting firms.

Keywords:
accounting firms; co-operative compliance; corporate tax; effective tax rates; knowledge management; tax avoidance; tax planning

1. INTRODUCTION

The global economic crisis has seen increased research effort and international attention on corporate tax planning and avoidance (Desai and Dharmapala, 2009a; Dyreng et al. 2010; Lisowsky, 2010; Hanlon and Heitzman, 2010). The focus on tax avoidance, which is often prefaced with the adjective 'unacceptable', and the use of 'aggressive' planning involving tax havens and profit-shifting techniques is a major concern to governments (OECD, 2011) who must balance their desire to offer companies a 'pro-business' tax environment that encourages investment, for example through corporate tax rate reductions, while still maintaining the tax base and corporate tax receipts.

In the U.K., campaigners have taken direct action against firms such as Vodafone, Alliance Boots and Top Shop.[1] Direct action has now spread across the Atlantic with US Uncut targeting Bank of America. The emergence of protests against alleged tax avoiders has the potential to affect corporate reputations, with Richard Lambert (ex-Director-General of the Confederation of British Industry) quoted in the Financial

* Respectively, University of New Hampshire, University of Southampton and University of Nottingham. We acknowledge helpful comments on an earlier draft of this manuscript from Gregory Morris and seminar participants at the University of Massachusetts-Boston, University of New Hampshire, University of New South Wales (Atax) and Victoria University of Wellington.

[1] See www.ukuncut.org.uk.

Times stating: "It's worrying to the extent it gives an impression that business is not paying taxes in the way it should. It gives a misleading impression of the role of business in society" (Houlder et al. 2010). Campaigning in the U.K. is also conducted by organisations such as Tax Justice Network and, arguably, extends to the accounting literature, with Sikka and Willmott (2010) highlighting the "dark side of transfer pricing" and Sikka (2010) citing the cases of Enron, WorldCom and individual practitioners from KPMG and Ernst & Young. Sikka (2010, p. 153) argues that researchers have paid little attention to companies and large accounting firms' "organised hypocracy" of promises of responsible conduct but actual indulgence in tax avoidance and evasion.

The increased presence of market-based tax avoidance research in leading accounting journals (e.g. The Accounting Review and Journal of Accounting and Economics), case-based comment in critical accounting journals (e.g. Critical Perspectives on Accounting and Accounting, Organizations and Society), together with increasing attention from policy makers and campaigning groups on both sides of the Atlantic (e.g. Tax Justice Network, Occupy movement, UK Uncut; US Uncut etc.) provides our motivation to 'set the scene' and provide a perspective on the U.K. corporate tax environment.

In this paper, we draw upon prior research on tax avoidance and effective tax rates (ETRs), as well as international administrative and policy responses to tax avoidance.[2] The successful implementation of planning and avoidance ultimately relies on companies effectively developing, managing and sharing tax knowledge (Hasseldine et al. 2010). Our contribution is to contextualise tax avoidance and identify actors and related behaviour for researchers, tax agencies, accounting firms, corporate taxpayers, and other stakeholders including society at large. For example, one direct consequence of more corporate tax research is that the factors associated with corporate tax (non)compliance may be identified (Hanlon et al. 2007). Attention to other areas is also likely to reap benefits. These include documenting the effects of known tax avoidance on corporate reputation and consequential firm value effects (Hanlon and Slemrod, 2009). Finally, we note that major cross-country differences exist in the regulation of tax practitioners (i.e. accountants and other agents) between countries such as Australia and the U.S. versus the U.K.

The paper is structured as follows. In the next section, we identify the actors in the U.K. corporate tax environment, discuss their respective roles and incentives, and outline prior research on recent developments in tax avoidance and corporate tax compliance. Section three provides a synopsis of prior research on ETRs, tax planning and avoidance and extant literature on tax accounting practice and tax knowledge. Section four provides a perspective on the policy responses to tax avoidance including divergent practices in the regulation of tax practitioners. Section five offers some concluding remarks.

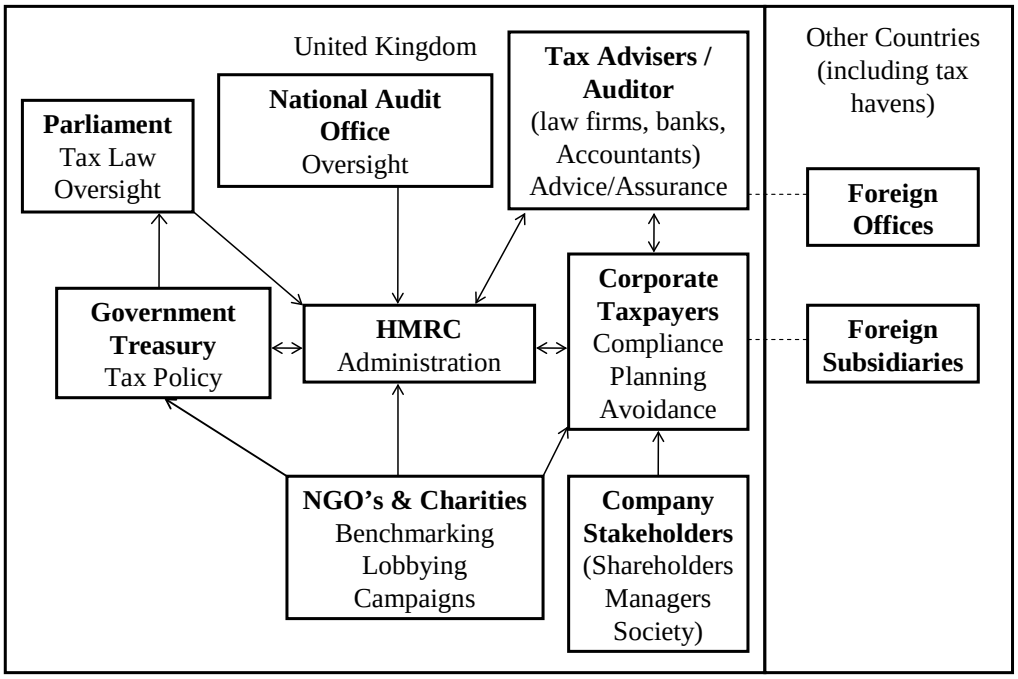
[2] We consider U.K. literature but also a relatively large number of non-U.K. studies. The reason for this is that U.S. based quantitative researchers have access to large datasets, and the two countries share similar capital market features and companies tend to focus on shareholders as their primary stakeholders.

2. THE CORPORATE TAX ENVIRONMENT

2.1 Actors and Actions

Figure 1 provides an overview of the participants (or actors) in the U.K. corporate tax environment. This section briefly outlines the role and incentives of each party with more detailed analyses on corporation tax rates and revenues available elsewhere (Devereux and Loretz, 2011). First, the U.K. Government and Her Majesty's Treasury are responsible for formulating tax policy, which is then enacted into tax law through Parliament.[3]

Figure 1: Actors and Relationships in the U.K. Corporate Tax Environment



Her Majesty's Revenue and Customs (HMRC) is responsible for the administration of tax law and was established in 2005 following a review by Sir Gus O'Donnell into the two former revenue departments (HM Treasury, 2004). At the same time, the (then) Paymaster-General launched a review of HMRC's powers, deterrents and safeguards

[3] Detailed discussion on the actual process of enacting tax legislation (i.e. consultation, drafting and use of Select Committees etc.) is beyond the scope of this paper. Interested readers can refer to CIOT (2010).

in a bid to modernise areas that were not working well. Using a consultative approach, the 'Powers' review has initiated change in debt management and investigation powers, civil and criminal penalties, compliance checks and taxpayer safeguards, in respect of both taxpayers and their advisers (HMRC, 2005).[4] Since 2008, in a shift from prior practice, HMRC has been governed by a non-executive chairman and oversight is provided by the National Audit Office and the Public Accounts Committee of Parliament.

From a compliance perspective, corporate taxpayers must capture, or, at least access, tax knowledge and implement informal and/or formal systems to enable routine tax compliance while engaging in volitional planning and avoidance activity as determined by various factors (see subsequent discussion in Section three). Prior survey evidence suggests that larger companies are more likely to have an in-house tax department (Porter, 1999).

External advisers act as intermediaries between companies and HMRC and include law firms, accounting firms (e.g. the 'big four') and banks. Law firms may be used when disputes lead to possible/actual litigation, for advice on specific transactions and for procuring legal opinions. Clearly, advisers have a vested interest in a certain level of tax system complexity (McKerchar et al. 2008).

Company management are themselves stakeholders (Dyreng et al. 2010), together with existing and future shareholders, who wish to maintain shareholder value and avoid reputation risk. Prior research by Hasseldine et al. (2010) suggests the principal motives of U.K. corporate taxpayers for using an external adviser are their awareness of the legislation and their experience in the practicalities of tax compliance. They also find that almost two-thirds of corporate taxpayers agreed that using an external tax adviser is designed to provide insurance against a tax risk although advisers agreed significantly less on this motive.

While tax law is national and levied democratically by sovereign states, globalization means corporate activity frequently spans international borders. Multinational firms are not just faced with the U.K. corporate tax environment, but an international corporate tax environment. This entails compliance with local tax laws and dealing with foreign tax agencies in every country in which they operate, which may well include tax haven countries. Even small and medium sized enterprises (SME's) are likely to deal with foreign tax jurisdictions.

Given that the big four accounting firms also operate world-wide, and tax administrations do not, the latter have worked to seek out and share 'best practice', often accomplished with the assistance of international agencies such as the OECD, IMF and World Bank.[5] Owens and Hamilton (2004, p. 348) provide international context, suggesting that tax administration problems reflect not so much the behaviour of the tax agency, rather what they have to administer viz:

[4] One of the authors was a member of the 'Powers' Consultative Committee from 2005 – 2011.
[5] Readers are referred to www.itdweb.org.

> "In looking at the root causes of problems in tax administration, what needs to be considered is what is being administered: the tax law and how it is interpreted. And problems caused by the law cannot be considered until one reflects on the efficacy and practicality of the tax policy that the law is meant to implement. The entire system, all of its players, their behaviours, and drivers of those behaviours need to be considered in an objective, holistic, and systemic manner if countries are going to tackle successfully their crises in tax administration."

Until Aaron and Slemrod's (2004) Crisis in Tax Administration volume focused on the U.S., there had been a paucity of scholarly tax administration research.[6] This is shifting with more published research on the topic (e.g. Hasseldine, 2011) and has been assisted by specialist biennial conferences on the topic under the auspices of the Australian School of Taxation at the University of New South Wales.

In the U.K., a review of HMRC in 2007 concluded that the department was complex, both in terms of its many constituent parts and in terms of its matrix management structure that did not relate roles and responsibilities amongst its senior management to accountability (Cabinet Office, 2007). Yet, in both the U.S. and U.K., when examining tax agency performance, one contributing factor to the "crisis in tax administration" is that tax agencies face budget constraints, especially in times of public spending cuts, and are often under-funded (Owens and Hamilton, 2004; Shaw et al. 2010).

As noted above, following the lead of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, tax agencies such as the IRS and HMRC and others are co-operating more closely with each other. IRS Commissioner Douglas Shulman (2010), in a speech to the OECD, suggests that tax administration is progressing from simple co-operation to coordinated action on global tax issues. Areas likely to be targeted are joint audits (where two or more countries join together to carry out a single audit of a company with cross-border business activities), information exchange, offshore tax compliance and a continuation of the Joint International Tax Shelter Information Centre (JITSIC).

A final group of stakeholders are NGO's and charities (e.g. Oxfam, ActionAid) who are motivated by the desire to reduce the use of tax havens and promote a 'fair deal' for developing countries (see Palan et al. 2010). This bridges calls made for corporate social responsibility in the area of tax. Sikka (2010) strenuously argues that multinationals and their advisers (Sikka, 2008) who champion CSR are themselves engaging in tax avoidance and evasion. Christensen and Murphy (2004) espouse similar views. The argument tends to be that a 'fair' amount of taxation is not being paid, and that such corporates are contributing to the tax gap (HMRC, 2010). Some socio-legal scholars also argue that aggressive planning within the law is problematic (McBarnet, 2003).

[6] Such research is distinct from the separate and extensive literature on taxpayer compliance and taxpayers' costs of compliance.

Not surprisingly, accounting firms are keen to demonstrate their expertise and credentials in this area, with one example being the Total Tax Contribution framework of PwC and Williams's (2007) KPMG paper providing a detailed perspective on tax and CSR. Ultimately, it would appear that CSR is a legitimate concern for corporate taxpayers, especially given that corporate reputation effects may ultimately affect shareholder value.

Desai (2012, p. 136) states that "the complexity of the current [U.S.] system and the proliferation of tax avoidance techniques have made the corporate tax optional for many global corporations". Yet, Desai and Dharmapala (2006b, p. 5) note that while tax avoidance is widespread, shareholders and tax collectors share a common interest in constraining opportunistic managers, as "tax avoidance demands obfuscation and this obfuscation can become the shield for actions that are not in the interests of shareholders or tax authorities". They suggest that corporate malfeasance is linked to tax avoidance behaviour, and in their parlance, CSR is "the missing link". Desai (2012, p. 139) suggests that CSR practice by the corporate sector might embody tax obligations at a commensurate level with, say, environmental regulations.

So while there is not yet a mainstream recognition of tax and CSR (as opposed to the impact of a firm on the environment for example), Hasseldine and Morris (2012) believe it promises to be a key growth area for future research. Notwithstanding the "missing link", prominent social campaigns, may also force companies to (re)consider their reputation and provide greater transparency in the area of tax reporting. However, given that country by country tax reporting would be costly and difficult for multinationals, and is not currently supported by policy makers (given the lack of legislation),[7] it seems likely that providing such tax disclosures in an understandable format would be extremely challenging, not only for the providers of the information, but for the users of it as well (Bruce, 2011).

3. SCHOLARLY LITERATURE

3.1 Companies' Tax Actions – Planning and Avoidance

The existence of different effective tax rates (ETR) is sometimes taken as an indicator of 'missing' tax.[8] Yet, these can vary across companies for many legitimate reasons. These include a company carrying forward losses from prior years or it may have large depreciation allowances. Any of these conditions may qualify the company for relief under the tax law and so reduce its tax liability. Simply observing cross-

[7] Notwithstanding, note the European Commission has recently engaged in a public consultation exercise on country-by-country reporting by multinationals and the Council of the European Union, meeting in Brussels in March 2011 invited "the Commission to come forward with initiatives, in consultation with Member States and relevant stakeholders, on the disclosure of financial information by companies working in the extractive industry, including the possible adoption of a country-by-country reporting requirement, International Financial Reporting Standards (IFRS) for the extractive industry, and the monitoring of third-country legislation. " (Council of the European Union, 2011).

[8] ETRs express a company's tax charge for a period relative to its accounting profit. Definitions vary around, for example, the treatment of deferred tax. A related measure is the book-tax gap which is based on the difference between the grossed-up tax charge, proxying for taxable income, and pre-tax accounting income. These two measures differ only in the sense that ETRs capture the tax saved while the book-tax gap is in gross terms, i.e. income (Abdul Wahab and Holland, 2012).

company differences in ETRs, or that a firm's ETR is less than the statutory corporate rate, therefore says little about the amount of tax avoided, although where companies do engage in planning or avoidance, this affects their ETR relative to what would have otherwise applied if the tax planning or avoidance had not been undertaken.[9]

Accordingly, research has examined whether there is a link between ETRs and firm size (e.g. Callihan, 1994; Holland, 1998) and has tested for associations with other characteristics such as capital intensity, leverage, industry membership as well as the influence of tax preferences (Gupta and Newberry, 1997).

Mills (1998) extended ETR research and pioneered U.S. efforts into differences between income for financial reporting purposes and taxable income (now known as the book-tax gap). Such gaps are not surprisingly associated with tax audit adjustments (Cho et al. 2006) and are treated as red flags in risk measurement exercises of various tax agencies (see Appendix).

Empirical tax researchers in the U.S. and more recently in the UK have recently addressed tax avoidance and tax shelter participation more directly, and in relation to financial reporting (including links with earnings management). Thus, the focus has now shifted to investigations of underlying motives and economic consequences (Desai and Dharmapala, 2006a; 2009b). This involves drawing a distinction between active steps, described variously as tax avoidance, tax planning or tax management, and passive or secondary effects e.g. reduction in corporate income tax arising from an operational decision to acquire an asset qualifying for capital allowances or issuing debt for primarily non-tax reasons (Frank et al. 2009) where such decisions are not motivated by any tax consideration whatsoever. Insights provided are that the basis of remunerating managers, whether on a pre- or post- tax basis (Phillips, 2003) or linked to share price (Abdul Wahab and Holland, 2012; Desai and Dharmapala, 2009b), ownership structure (Chen et al. 2010) and wider corporate governance considerations are all associated with levels of observed tax avoidance.

There is co-operation between the IRS and researchers with Lisowsky (2010) using a confidential dataset to model tax shelter participation. He shows that shelter participation is positively linked with subsidiaries in tax havens, foreign-source income, inconsistent book-tax treatment, litigation losses, use of promoters, profitability, and size, and is negatively related to leverage. These results confirm the risk measurement approach of both the IRS and HMRC (as outlined in the Appendix).

Collectively, researchers can now measure proxies of tax avoidance, identify its firm level determinants (incentives and control mechanisms), and consequences in terms of firm value, market reactions to tax shelter involvement and whether shelter firms carry less debt. Dyreng et al. (2010) even show, using a sample of 908 executives, that individual executives (i.e. CEO, CFO etc.) play a significant role in determining the level of tax avoidance undertaken, incremental to firm-level characteristics.

[9] The effect will depend on whether the tax planning results in a permanent avoidance of tax or the deferral of a liability.

Tax avoidance has also been subject to qualitative research approaches (e.g. Freedman et al. 2009; Mulligan and Oats, 2009) and this U.K. based research has started to investigate the relationships between the parties in the corporate tax environment.[10] Exemplars include research on large companies' relationships with tax agencies such as HMRC and the IRS (Oats and Tuck, 2008; Mulligan and Oats, 2009; Toumi, 2008) and these researchers have stressed the company's risk attitude, desire for maintaining corporate reputation and good tax governance as important considerations for large multinationals. Similar research has also been commissioned by tax agencies themselves (e.g. HMRC, 2007), and the need for tax risk management is promoted by big four accounting firms (e.g. KPMG, 2010; PwC, 2004).[11] To our knowledge, there is no prior research in this area which has been conducted with SME's.

3.2 Accounting firms as intermediaries, tax practice and tax knowledge research

The research on tax planning and avoidance just discussed reflects the complex, technical and vested nature of the corporate taxation environment (Mulligan and Oats, 2009; Oats and Tuck, 2008). Prior work on tax knowledge per se, is however largely restricted to experiments exploring individual tax professionals' judgements and decisions such as search processes and expertise (Bonner et al. 1992; Cloyd and Spilker, 1999; Gibbins and Jamal, 1993). Our focus here is on aggregate tax system-wide knowledge flows and effects as schematically shown in Figure 1.

Accounting firms are brokers of tax knowledge. By definition, they operate as intermediaries between corporate taxpayers and tax agencies (OECD, 2008; Hasseldine et al. 2011). Prior research in tax compliance suggests that tax accountants enforce non-ambiguous tax law while exploiting ambiguous tax law (Klepper et al. 1991; NAO, 2010). The decision to hire an accounting firm as an adviser may be driven by a lack of knowledge about tax legislation (Morris and Empson, 1998), or as a form of 'insurance' pending a perceived response from a tax agency (Hasseldine et al. 2011), or the corporate taxpayer may hope to reduce the probability of the external auditor subsequently objecting to the proposed financial accounting treatment of a particular tax transaction in which the accounting firm was involved (Maydew and Shackelford, 2007), particularly when the tax adviser also acts as financial auditor.

There is little prior research on the 'big picture' of tax knowledge. Porter (1999) surveyed 156 major U.K. companies and for the firms that had an in-house tax department in 1995, she reported that firms spent about 60% of their time on routine compliance and 38% on tax planning and advisory services. A more recent example is Hasseldine et al. (2011) who report on 26 interviews held with participants from accounting firms, corporate taxpayers and HMRC. They find that accounting firms vigorously try to establish and sustain a strong intermediary position between HMRC and corporate taxpayers, which is acknowledged by HMRC who are also aware of the simultaneous benefits and disadvantages that accrue with tax agents (i.e. the positive

[10] Lavermicocca (2011) reports on tax risk management practices based on qualitative interviews with Australian large company tax executives.

[11] Of course, one may argue that it is not surprising accounting firms highlight tax governance and risk management in their quest to market consultancy services!

'enforcer' role vs. the 'exploiter' and 'complexifier' role). Hasseldine et al. (2011) conclude that despite the use of co-operative compliance models, there remains an unavoidable tension between customer-friendly initiatives, based on responsive regulation and co-operative approaches, and policy and administrative responses targeted at tax avoiding companies which are now outlined.

4. POLICY RESPONSES

4.1 Response to tax avoidance – Cooperative Compliance

Traditionally, and based on the vested interests of the actors identified in the previous section, the relationship between tax agencies and taxpayers (and advisers) has been of an adversarial nature. A notable trend is that many western countries (see OECD, 2009) have adopted the use of the term 'customer' (Tuck et al. 2011) with a responsive regulation approach which promotes co-operative tax compliance. A team at Australian National University pioneered a compliance pyramid model based on procedural justice (Braithwaite, V. 2003), which has also been adapted for large business (Braithwaite, J. 2003). The intention is to enable, or force, taxpayers towards the base of the pyramid.

The alleged benefits of such compliance models are better "buy-in" and one consequence is that taxpayers (and their representatives) may take government/tax agency efforts to lower taxpayer compliance costs at face value, rather than with cynicism. HMRC has embraced co-operative compliance, and for its large business customers, this has led to the introduction of Customer Relationship Managers (CRMs) and new systems of compliance risk assessment, resulting in the classification of a company as either "High" or "Low" risk and consequential effects in terms of being audited (NAO, 2007; OECD, 2009; Appendix).

However, not all scholars fully endorse an 'enhanced relationship' approach. Kornhauser (2007) suggests that a tax authority following the compliance model risks being perceived as either too lenient or too hard in its approach, both of which might decrease tax compliance. She notes that a flexible system (required for responsive regulation) might lead to arbitrary decisions that actually undermine procedural fairness. Burton (2007) also critiques the approach, suggesting that it is particularly problematic as tax law is often indeterminate. This is especially the case for tax laws affecting large companies which are often uncertain, complex, and not always objective. Accordingly, different interpretive paths might produce different interpretive meanings, choices and actions.

Aside from various administrative responses discussed earlier, such as co-operative compliance models etc., there are several policy responses that the international community has, arguably, been proactive in dealing with in addressing international evasion and avoidance (e.g. the OECD's project on Harmful Tax Practices). However it is beyond the scope of this paper to consider every international policy response to tax avoidance. For example, countries report different experiences with the use of general anti-avoidance rules (adopters including Australia, Canada, Hong Kong, New Zealand) versus non-adopters such as the U.K. (see Freedman, 2008). However, tax avoidance in the U.K. has been such a pressing issue, that a Committee chaired by

Graham Aaronson QC (2011) recommended a GAAR targeted at artificial and abusive tax avoidance schemes with a consultation period in 2012 and likely legislation in 2013. Notwithstanding these developments we draw on themes in western tax agencies, over and beyond the co-operative compliance approach mentioned in Section two.

In the main, tax agencies have responded with more targeted audits and increased requirements for disclosure and greater transparency (e.g. for senior accounting officers in the U.K. and companies with 'uncertain tax positions' in the U.S. - Traubenberg, 2010) in a similar manner to the Australian Tax Office' focus on tax governance in large business over the last few years. Information exchange is another theme, with several hundred bilateral tax information exchange agreements (TIEA's) being signed between OECD and non-OECD countries, following projects on harmful tax practices and high net-worth individuals.

Recently, the OECD (2011) published a report on disclosure initiatives which documents the international use of early mandatory disclosure rules (especially aimed at promoters), additional reporting obligations (e.g. on capital losses), questionnaires to help with tax audit selection and penalty-linked disclosure rules (offering concessions for voluntary disclosures).

The approach of HMRC has been likened to "an iron fist in a velvet glove" (Bruce, 2011) as HMRC has operated a tax avoidance disclosure regime since 2005, and received disclosures of 2,035 direct tax schemes in the first five years, which then informed 49 anti-avoidance measures (Oats and Salter, 2008; OECD, 2011).

The rationale for policy responses in the U.K and elsewhere involving disclosure and transparency can be summarised as tax agencies wanting to 'tilt the scales' in their favour. With greater knowledge on current practice, they are able to respond directly to tax avoidance with new legislation, or seek to influence corporate tax compliance through co-operative arrangements as outlined in Section two.

Efforts are being made to influence companies' motivations to avoid tax. For example, a code of practice for banks, introduced in 2010, specifies that: "The Government expects that banking groups, their subsidiaries, and their branches operating in the UK, will comply with the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament". The U.K. government (and consequently, the voter/taxpayer) part-owns two major combined high street and investment banks, which gives it increased influence over U.K. banks' tax behaviour. Following pressure from the Chancellor of the Exchequer, the top 15 banks operating in the U.K. signed up to the 'voluntary' Code of Practice on Taxation (Osborne, 2011).

Nonetheless, not everyone agrees with use of the "spirit" of the law as opposed to the "letter" of the law. Contrary to McBarnet et al. (2009), arguably there is no need for a distinction between the "letter" of the law and the "spirit" of the law, and given the difficulties associated with trying to determine the intention of a collective body (i.e. UK Parliament) other than through the enacted tax law, there is no need to seek any further than the actual legislation (Hasseldine and Morris, 2012; Hoffman, 2005). However, unlike activists, tax practitioners (and their professional associations) tend

to believe that if a tax agency feels a claim is not within the "spirit" of the law, then better legislation should be drafted and enacted (ICAS, 2008).

4.2 Regulating tax practitioners

While financial reporting is becoming more harmonised through the use of IFRS (Desai and Dharmapala, 2009b), tax practice and the regulation of tax practitioners remain areas of international difference due to national sovereignty (e.g. McKerchar et al. 2008; Tran-Nam and McKerchar, 2012). Further, while tax agencies share best practice, differences in international regulatory style will arise from national context and culture (Sakurai, 2002). There is also competing evidence (Erard, 1993; Hite and Hasseldine, 2003; Salter and Oats, 2011; TIGTA, 2008) on whether returns prepared by practitioners are associated with more, or less, compliance than returns prepared without the assistance of a practitioner, again supporting the characterisation of practitioners as both enforcers and exploiters.

In the U.S., there have long been rules in Treasury Department Circular No. 230 governing practice before the IRS, and these have been strengthened from time to time, most recently with the requirement for all preparers to hold a Preparer Tax Identification Number (PTIN) number, and to possess certain competencies (GAO, 2011a; GAO 2011b; Tran-Nam and McKerchar, 2012). Regulations are even more stringent in the states of Oregon and California as noted by GAO (2008) and McKerchar et al. (2008).

In contrast to the U.S. and Australia (see Tran-Nam and McKerchar, 2012), in the U.K., there are no explicit requirements in order to be a tax agent. Yet, following a recent report from the National Audit Office (2010), and perhaps, lesson-drawing from other tax agencies such as the IRS and Australian Tax Office, HMRC is paying more attention to the role of tax agents and is in the process of introducing new legislative powers involving sanctions and access to agents' working papers (HMRC, 2009; Salter and Oats, 2011). Not surprisingly, the accounting profession has resisted such efforts, suggesting that self-regulation is their preferred option and that they can 'look after it themselves' through their own disciplinary procedures (e.g. ICAEW, 2010). Of course, some tax agents are not affiliated with any professional body and this strengthens the argument for regulation, at least of unaffiliated agents.

5. CONCLUDING REMARKS

The study of the actors in the U.K. corporate tax environment, their actions and the consequences has hitherto been a neglected topic in scholarly journals. This paper's contribution is to contextualise tax avoidance and to motivate further research by documenting linkages between the actors in the environment, prior U.S. research, and policy responses. We believe that further research can be conducted using a variety of research methods and methodologies (e.g. archival, experimental and qualitative work). Tax avoidance is believed to be widespread and as other researchers have shown is linked closely to financial reporting, economic consequences and society at large.

Prior research by Hasseldine et al. (2010) highlights that demand for the role played by accounting firms is driven by the difficulties companies have in interpreting tax legislation and the ability of advisers to provide administrative compliance as well as promoting tax avoidance schemes. Accounting firms may not always recognise the motives of corporate taxpayers in engaging them. For instance, corporate taxpayers report one reason for purchasing tax advice is as a form of insurance, whereas this was rated as unimportant by accounting firms. Consequently, tax advisers may be inadvertently further increasing the demand for tax avoidance activities by reducing its potential costs, particular if they are unaware that they are providing such insurance. This has implications for restricting auditors on the extent to which they can provide tax related non-audit services and may justify regulation of all tax advisers and not just those who are members of a professional association.

This perspective paper also reinforces earlier work on the dual role played by accounting firms i.e., their superior abilities in tax knowledge management allow them to be both enforcers and exploiters in the tax system (Klepper et al. 2001). This suggests that the policy response to regulating tax practitioners, in which there is considerable international divergence, needs to be carefully balanced by governments and tax agencies.

In the future, we believe that archival corporate tax data will become more readily available and that research into corporate tax practice (including planning and avoidance activity) should remain high on the agenda not just for future researchers, but also for other users such as tax agencies, accounting firms and companies themselves, and society at large.

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Appendix: Tax Agency Use of Large Business Compliance Risk Indicators

United Kingdom

HMRC rates behavioural and organisational compliance risk in seven areas in order to determine the risk a taxpayer presents. These areas are listed below together with a couple of examples of high-risk behaviour.

In terms of tax contribution, the trend of receipts will show a significant falling pattern in one or more tax regimes with no clear reason and there is likely to be significant divergence of taxable profits compared with commercial profit levels.

In terms of complexity, the business typically operates within a highly complex structure but has no clear strategy or procedures to ensure completeness or best practice arrangements. Highly complex tax issues are considered on an ad hoc basis and there are likely to be very high tax throughputs in a number of different tax regimes.

In terms of boundaries, examples of major risk include a foreign owned business with a lack of knowledge or clarity around the global business interest. Others include complex and diverse business structures with major connected party interests and activity, complex transfer pricing transactions, extensive involvement with tax havens and UK based businesses using offshore entities with tax avoidance as the driver.

In terms of change, the business is likely to have numerous acquisitions and disposals, but with no strategy for change management. The business is likely to react routinely to industry and commercial or other pressures with no consideration of tax consequences.

In terms of governance, the tax strategy is likely to be un-stated with unclear accountabilities and authorities and/or the Board will be unsighted on significant tax issues. There will be limited co-operation in identifying and resolving issues, sharing information or de-risking systems or processes and no evidence of commitment to build a trusting partnership with HMRC based on an open, transparent, and meaningful dialogue.

In terms of tax strategy, the business will be heavily involved in tax planning with no commercial context and there will be significant use of loopholes or anomalies in the law to minimise tax or duties.

In terms of delivery, the business will have a history of regular and significant mis-directions or late declaration or payments of tax in a number of tax regimes. Tax teams will be poorly supported or under resourced both in terms of numbers and in terms of adequate skills.

United States Large and Mid-Size Business Unit

The principle risk factors that LMSB focuses on when screening or risk assessing corporations mostly relate to the ability of large companies to exploit complexity:

- complexity in tax law;
- business structure; and
- accounting and financing.

Compliance Risk indicators include, but are not limited to the following:

- extensive international business activities (opportunities for transfer pricing and cost sharing tax avoidance);
- transactions with corporate affiliates or third parties in tax haven countries (basis shifting, export of intangibles);
- transactions with other "tax advantaged entities" (tax-exempt entities, entities with unused credits, losses or preferential tax rates: asset/basis shifting, leasebacks, arbitrage schemes, etc);
- use of Special Purpose Entities (a.k.a. "Variable Interest Entities": entities set up to achieve a specific financial and/or tax planning purpose: to own specific assets, handle specific transactions, etc. These are often short-lived entities, often flow-through, often tiered);
- complex entity structures (consolidated financial reporting entity differs from the consolidated tax reporting entity: separate tax filings by some corporate affiliates, extensive use of flow-through entities to report some business activity, etc.);
- use of complex hybrid and derivative financial instruments (techniques for claiming tax advantages of debt [interest expense deductions, bad debt losses], and equity [dividend received deductions, capital gains treatment] on the same financing transactions);
- tax incentives for specific types of economic activity (tax rules and regulations that give preferences for favoured activities such as research & experimentation credit, domestic production, alternative energy production, etc. become tax planning opportunities for "substance vs. form" accounting and reporting);
- tax incentives offered by competing tax jurisdictions (opportunities for companies to engage in "tax arbitrage" planning, such as foreign tax credit generators, shifting of supposed business locus);
- computerized and web-based business and accounting systems (to enable greater complexity, fractionating of transactions, disassociation of economic activity from a specific location, etc.);
- management focus on management of profit reporting (aggressive financial management that requires tax departments to be managed as "profit centers", and competition between accounting and legal practitioners to promote tax planning techniques to reduce effective tax rates and increase cash flow);
- book-tax reporting differences (opportunities for tax and financial accounting manipulation created by complex and inconsistent accounting systems: US tax accounting vs. foreign tax accounting vs. US Generally Accepted Accounting Principles vs. International Financial Reporting Standards. "Rules" vs. "Principles" based accounting. Companies that report their activities using multiple different accounting systems have opportunities to shift transactions to benefit accordingly);
- competitive pressure to drive down ETR (Effective Tax Rate – so called "tax efficiency" measures used by investors and others to compare companies); and
- history of restatements of financial reports required by Securities and Exchange Commission.

This is only a partial list, and many of these factors work together or are inter-related. These are all conditions that enable large companies and their tax planning advisors to initiate or participate in non-compliant tax planning and reporting activities. Many of these factors have been extensively studied and measured.

Source: OECD (2009, pp. 19-20)

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Australia's carbon policy – a retreat from core principles

Evgeny Guglyuvatyy*

1. INTRODUCTION

Successive Australian governments have been committed to the introduction of an emissions trading scheme (ETS) designed to mitigate climate change.[1] In December 2006, the then-Prime Minister John Howard announced that Australia would move towards a domestic emissions trading system, to start no later than 2012.[2] The subsequent Rudd government proposed an Australian Carbon Pollution Reduction Scheme (ACPRS) in 2008. The proposed ACPRS had two objectives: first, to meet Australia's emissions reduction targets in the 'most flexible and cost-effective way'; and second, to sustain a global response to climate change.[3] The ACPRS legislation was twice defeated in the Australian Parliament in 2009. As a result, at the beginning of 2010, the government put the ACPRS on hold. Later in 2010, the government announced its intention to propose a temporary carbon pricing scheme,[4] and also, set up the Multi-Party Climate Change Committee (the Committee)[5] consisting of members of the federal government and senators.[6]

* Lecturer, University of Technology, Sydney. Part of this paper is derived from the author's PhD thesis undertaken at Atax, The University of New South Wales. The author would like to thank Professor Chris Evans for his constructive comments that helped improve the manuscript.

[1] Wilder M. and Fitz-Gerald L. 2009, Review of policy and regulatory emissions trading frameworks in Australia. AERLJ, vol. 27, pp. 1-22.

[2] Ibid. Note, however, that in 2005, the Australian State and Territories issued a discussion paper concerning a national emissions trading scheme which would cover the power generation sector.

[3] CPRS. 2009. *Carbon Pollution Reduction Scheme*. p. 10. Available at (Accessed 15/03/2011): http://www.climatechange.gov.au/government/initiatives/cprs.aspx.

[4] A carbon pricing scheme is often called a 'tax' because during the fixed price period, the liable parties are obliged to purchase fixed price carbon units which is similar to paying tax. However, they cannot trade the units on the market, as under an emissions trading scheme.

[5] Multi-Party Climate Change Committee. Available at http://www.climatechange.gov.au/government/initiatives/mpccc.aspx.

[6] The Committee includes: the Prime Minister, the Hon Julia Gillard MP, the Deputy Prime Minister, the Hon Wayne Swan MP and the Minister for Climate Change and Energy Efficiency, the Hon Greg Combet AM MP, joined by co-deputy chair of the Committee, Australian Greens Deputy Leader Senator Christine Milne, Australian Greens Leader Senator Bob Brown, Mr Tony Windsor MP, and Mr Rob Oakeshott MP. The Committee is assisted by the Parliamentary Secretary for Climate Change and Energy Efficiency, Mr Mark Dreyfus QC MP and Mr Adam Bandt MP, and by expert advisors Professor Ross Garnaut, Professor Will Steffen, and Mr Rod Sims.

The Committee's intention was to establish a climate change framework outlining the broad architecture for a carbon price. The Committee issued eleven policy principles designed to provide a consistent basis for the deliberations on a carbon price.[7] The principles were as follows:

- Environmental effectiveness
- Economic efficiency
- Budget neutrality
- Competitiveness of Australian industries
- Energy security
- Investment certainty
- Fairness
- Flexibility
- Administrative simplicity
- Clear accountabilities, and
- To support Australia's international objectives and obligations.[8]

The Multi-Party Climate Change Committee stated that the 11 principles will guide the design decisions of the pricing mechanism. The Committee also specified that these principles should direct the development of any carbon price mechanisms.[9] Thus, it is reasonable to suggest that both policies – the transitional carbon price mechanism and future emissions trading – should be in accordance with these principles. However, even at first sight, the proposed legislation does not seem to reflect these criteria adequately. In this light it is tempting to examine the proposed legislation more closely to identify how well it addresses the 11 principles. Although, analysing the entire division of climate change policy, including all of the relevant policies, would be an enormous task. Thus, this paper will discuss only the major characteristics of the proposed instruments and their potential capacity to address the principles (criteria) established by the Committee.

2. THE CARBON PRICING SCHEME

The Committee released draft legislation on 28 July 2011. In October 2011, the Australian House of Representative passed the carbon pricing legislation which was later approved by the Australian Senate. The carbon price scheme (the scheme) operates from 1 July 2012 as a temporary measure designed to reduce greenhouse gases (GHG). The carbon price is $23 for the 2012–13 financial year and increases by 2.5 per cent in each of the following two years.[10] Under the scheme, liable entities buy and surrender carbon units equal to their direct emissions (based on historic levels) of carbon dioxide equivalents (CO2). Failure to surrender necessary carbon units will result in a fine. After the transitional period, the carbon price mechanism converts to a cap-and-trade ETS supplying a flexible carbon price.[11] From 1 July 2015, the carbon

[7] Multi-Party Climate Change Committee. Available at: http://www.climatechange.gov.au/~/media/Files/minister/combet/2011/media/february/mr20110224.pdf

[8] It is important to note that the principles are not stated in any order of priority. See Multi-Party Climate Change Committee, above note 7.

[9] Multi-Party Climate Change Committee, above note 7.

[10] Multi-Party Climate Change Committee, above note 7.

[11] Ibid.

units will be auctioned. Hence, even though the carbon pricing mechanism is sometimes labeled a 'carbon tax', the Australian government is still committed to emissions trading.

The carbon price scheme covers four of the six GHGs counted under the Kyoto Protocol, including carbon dioxide (CO2), methane (CH4), nitrous oxide (N2O) and perfluorocarbon (PFC),[12] and has broad coverage of the following emissions sources:

- the stationary energy sector
- industrial processes sector
- fugitive emissions (other than from decommissioned coal mines), and
- emissions from non-legacy waste.[13]

The scheme covers around 500 entities which emit 25,000 tonnes of CO2 per year or more and certain waste facilities emitting more than 10,000 tonnes per year, constituting about 50 per cent of Australia's GHG.[14] Agriculture and transport fuels are excluded from the scheme, although transport fuels used by off-road heavy vehicles (except for agriculture, fishing and forestry) are covered indirectly by a reduction in existing fuel tax concessions. To transfer a carbon price signal to rail, domestic shipping and domestic aviation fuel tax excises have increased. The treatment of fuel will be reviewed in 2014. During the fixed price transitional period under the scheme, liable parties cannot use international emissions reduction units for compliance. However, during the flexible price period, internationally recognised permits may be used to acquit up to 50 per cent of a party's liability.[15]

There is no cap on emissions during the fixed price period and the number of carbon units is unlimited. However, starting from 2015–16, the Climate Change Authority (an independent statutory body which is yet to be established) will set a cap on emissions taking into consideration international and Australian emissions reduction targets. Currently, Australia is committed to reducing emissions by 5 per cent of 2000 emissions levels by 2020, and by 80 per cent of 2000 levels by 2050.[16]

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[12] Hydrofluorocarbons and sulphur hexafluoride will face an equivalent carbon price, which will be applied through existing synthetic greenhouse gas legislation.

[13] Stationary energy includes emissions from fuel consumption for electricity generation, fuels consumed in the manufacturing, construction and commercial sectors, and other sources like domestic heating. Industrial processes emissions are side-effects of production from non-energy sources, for example, it includes emissions from cement production, metal production, chemical production, and consumption of HFCs and SF6 gases. The fugitive emissions relates to the energy sector and covers emissions that are linked with the production, processing, transport, storage, transmission and distribution of fossil fuels such as black coal, oil and natural gas. The waste emissions relate to waste dumped at landfills.

[14] Multi-Party Climate Change Committee, above note 7.

[15] The Commentary on the provisions also states that international linking with the European Union scheme and New Zealand Schemes are desirable and if agreed, EU Allowances and NZ units would be prescribed under the Clean Energy Bill. (Multi-Party Climate Change Committee, above note 7).

[16] The Australian Government has been criticised for these low GHG reduction targets. For example, Professor Garnaut (the federal government's climate change adviser) recommended a 25 per cent reduction, while many other commentators suggest that an even more ambitious GHG reduction target is needed. See for example: Garnaut, R. 2008. *Australia Counts Itself out.* Available: http://www.theage.com.au/national/australia-counts-itself-out-20081219-72ei.html?page=-1; Brook, B. 2009. *Carbon Tax or Cap-and-Trade? The Debate we never had.* Available: http://bravenewclimate.com/2009/02/14/carbon-tax-or-cap-and-trade-the-debate-we-never-had/

It is projected that the carbon price scheme will raise $24.5 billion over its first four years. However, it will not be revenue neutral; the budget deficit is expected to be around $4 billion.[17] The reason for that is an extensive spending plan to compensate industries and households and to invest in renewable energy. There are significant tax cuts and increases in allowances, payments and benefits. In particular, the tax free threshold has almost tripled from the previous $6,000 to $18,200 from 1 July 2012, and then increase to $19,400 from 1 July 1 2015. Thus, all taxpayers with an income below $80,000 will effectively receive tax cuts from 1 July 1 2012.[18]

Further, an assistance package of $9.2 billion will be allocated over the first three years to Australian industries to eliminate competitiveness issues associated with the carbon price scheme.[19] Most affected industries such as steel, aluminium, zinc, pulp and paper makers will acquire free permits covering about 94.5 per cent of industry's average carbon costs. In addition, $300 million is to be assigned to the steel industry's shift to clean energy. A coal sector jobs package at $1.3 billion is dedicated for mines that are most affected by the carbon price.[20]

Further consideration has also been given to complementary measures that support research, development and commercialisation of green technologies. In particular, a $10 billion Clean Energy Finance Corporation will be created to invest in new technologies and $3.2 billion will be allocated to the Australian Renewable Energy Agency.[21] Additionally, small grants will be available for community-based energy efficiency programs. On top of that, the government is committed to closure of 2000 megawatts of the dirtiest power generators by 2020.

Overall, the broad architecture of the proposed carbon price scheme seems to resemble in some aspects the design of the previously introduced ACPRS.[22] However, the carbon price, in some respects, is a substantial improvement on the heavily compromised ACPRS. Generous compensation for affected industry is a temporary measure and based on historic emissions levels, thus the incentive to reduce emissions is not eroded. The assistance package for households is designed to compensate low and medium income earners rather than high income earners. Raising the income tax threshold allows taking about a million low income taxpayers out of the income tax system.[23] Finally, a range of supporting measures designed to encourage energy efficiency and green innovation is also a significant improvement.

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[17] Multi-Party Climate Change Committee, above note 7.

[18] However, the individual income tax rates for higher income earners are raised. For example: 19% for income over $18,200 (was 15%) and 32.5% for income over $37,001 (was 30%). Source: http://www.ato.gov.au/individuals/PrintFriendly.aspx?ms=individuals&doc=/content/00309813.htm.

[19] Multi-Party Climate Change Committee, above note 7.

[20] For details see: Carbon Pollution Reduction Scheme and Carbon Pricing Mechanism: comparison of selected features. Available at: http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Browse_by_Topic/ClimateChange/cprs.

[21] Ibid.

[22] For details see: CPRS. 2009, above note 3.

[23] Clean Energy Future. Available at: http://www.cleanenergyfuture.gov.au/wp-content/uploads/2011/06/09-FS-Household-Assistance-Tax-Reform-110708-1234hrs.pdf

3. AN ASSESSMENT OF THE CARBON POLICY AGAINST CORE PRINCIPLES

The preceding section discussed major design characteristics of carbon policy introduced by the Australian government. This section is devoted to evaluation of the carbon policy against each individual principal proposed by the Multi-Party Climate Change Committee. This evaluation will facilitate identification of the major shortcomings of the carbon policy.

3.1 Environmental effectiveness

The environmental effectiveness of climate change policy generally implies an effective reduction in GHG emissions. To evaluate the effectiveness of a policy option, it is necessary to determine whether the objectives are being achieved. However, ex-ante evaluation of the potential effectiveness of a policy is a key difficulty of much evaluation research.[24]

The environmental effectiveness criterion is strongly interconnected with the other criteria discussed below, but at this point it is taken as effective reduction of GHG emissions by the policy as defined by the Committee.[25] A transitional carbon price mechanism and future emissions trading could be equally appropriate for GHG reduction, despite having different characteristics. An existing experience, similar to the theoretical literature, does not provide clear guidance on the prioritising of one policy option over the other.[26] However, the ineffectiveness of existing carbon taxes and/or ETSs might be attributed to the low reduction targets and faulty design rather than the instruments themselves. In this light it is reasonable to suggest that, first of all, the effectiveness of these instruments would depend on the GHG reduction target established for a particular policy. Generally, a carbon policy must achieve significant GHG reduction in order to be effective. There are certainly many other factors influencing the effectiveness of climate change policies, but a considerable GHG reduction target is undeniably a critical prerequisite of an effective policy. Although the long-term target of 80 per cent is rather significant, the present short/medium-term reduction target set by the Australian government is inadequate.

The coverage of the policy is another important aspect directly related to the effectiveness of the policy in an environmental context. The carbon price scheme covers just about 50 per cent of GHG sources, providing a clear price signal to covered polluters but leaving aside another 50 per cent of polluters. The coverage of the scheme might be expanded in the future but at this point it is unlikely that this policy would create broad-based incentives across polluting sectors and activities. If

[24] Munda, G., Nijkamp, P. & Rietveld, P. 1994. Qualitative Multicriteria Evaluation for Environmental Management. *Ecological Economics*, 10, 97-112.

[25] All other discussed criteria are also considered according to the definition given by the Multi-Party Climate Change Committee.

[26] For example, carbon taxes implemented in Scandinavian countries have a narrow tax base, various exemptions and imbalanced tax rates. All these factors significantly reduce the environmental effectiveness of this instrument. Existing ETSs, so far, also have not demonstrated remarkable environmental effectiveness, being often linked with low reduction targets, limited coverage and grandfathering of permits. See for example: EEA. 2006. Using the Market for Cost Effective Environmental Policy. Available: http://reports.eea.europa.eu/eea_report_2006_1/en (Accessed 27/10/2009); Ellerman, D. & Joskow, P. L. 2008. The European Union's Emissions Trading System in perspective. Available: http://www.pewclimate.org/eu-ets (Accessed 27/10/2009).

transport and agriculture sectors are included in the scope of the scheme, the price signal would be adequate. Thus, considering the low emissions reduction target and limited coverage of the policy, its effectiveness is likely to be rather low.

3.2 Economic efficiency

According to the Committee, a carbon price mechanism should achieve emissions reduction cost-effectively and minimise the costs of emissions reduction to the Australian economy. This criterion is frequently prioritised by economists, although experts from other fields may not consider this criterion so favourably.[27]

In the short term, an emissions trading scheme is expected to raise prices more than revenue-equivalent fixed carbon price mechanism like a tax.[28] This is because marginal abatement costs increase quickly as abatement enhances, but emissions over any short interval make little difference to the accumulated stock.[29] Pizer argues that it is preferable to let the levels of emissions remain uncertain, as under taxes, than to allow the marginal price of emissions reductions to linger uncertainly, as under an ETS.[30] In other words, a fixed carbon price would by no means impose unreasonable costs on the reduction of GHG emissions, but a quantity target could.[31] Along this line, price certainty is an influential factor relating to economic efficiency. The long-term predictability of input prices is vital for investors and technological development. A fixed carbon price is able to convey a certain price signal to industry and consumers whereas an ETS price signal entails less certainty. Experience indicates that a price signal under ETS policy may fluctuate due to changes in economic conditions,[32] and it will therefore be impossible to predict the carbon price even for big business.[33] Under an effective ETS, price volatility would significantly affect business investments.

The recent global financial crisis clearly illustrates that markets are not self-sufficient. Likewise, it is not clear whether the ETS would be as functional and efficient as

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[27] For detailed discussion on various relevant criteria see: Guglyuvatyy, E. 2010. Identifying criteria for climate change policy evaluation in Australia. *Macquarie Journal of Business Law*, 7, 98-130.

[28] Aldy, J. E., Krupnick, A. J., Newell, R. G., Parry, I. & Pizer, W. 2009. Designing Climate Mitigation Policy. *Resources for the Future, Discussion Paper 08-16.*, p. 30. Washington DC.

[29] Ibid.

[30] Pizer concludes that: 'My own analysis of the two approaches [carbon taxes vs. emission trading] indicates that price-based greenhouse gas (GHG) controls are much more desirable than quantity targets, taking into account both the potential long-term damages of climate change, and the costs of GHG control. This can be argued on the basis of both theory and numerical simulations.' (Pizer, W. 2002. Combining Price and Quantity Control to Mitigate Global Climate Change. *Journal of Public Economics*, 85, 409-434., p. 432).

[31] Literature seems to agree that it is more difficult to achieve cost-effectiveness under an ETS, especially in the early years, due to price uncertainty. See for example: Pizer 2002; Aldy, J. E., Ley, E. & Parry, I. 2008. A Tax-Based Approach to Slowing Global Climate Change. *Resources for the Future, Discussion Paper 08-26.* Washington DC.

[32] See: Aldy et al. 2009 above note 28; Brook 2009, above note 16.

[33] Green et al. suggest that an ETS is not able to offer certainty since emissions permits do not legally represent real property rights. The government may modify the ETS regulation, which could diminish the value of emissions permits owned by industry. (Green, K. P., Hayward, S. F. & Hassett, K. A. 2007. *Climate Change: Caps vs. Taxes*. Available: www.aei.org/publication26286/)

planned, and whether prices of permits would remain reasonably stable.[34] The fixed carbon price, on the other hand, would levy the same burden on the polluters and provide similar incentives to implement environmentally-friendly technologies regardless of economic boom or decline. The carbon price scheme will provide more certainty over price than the ETS. Considering the criteria of economic efficiency, the certainty associated with a fixed carbon price would have an advantage over a flexible price, even if it is equipped with a price floor and ceiling, as under the future Australian emissions trading scheme.[35] From this prospective, the Australian government's commitment to an ETS may diminish the efficiency of the carbon price mechanism.

Another precondition of economic efficiency is the equivalence of the price signal. It is well recognised that economic efficiency can be increased if all polluters face the same carbon price. As discussed above, the proposed policy covers a limited range of GHG sources, accordingly decreasing its cost-effectiveness. Taken as a whole, the design defects of the policy, such as its coverage and GHG reduction target, may significantly influence its efficiency. In addition, the price volatility associated with the future ETS will negatively affect its performance; specifically, reducing the economic efficiency of this policy.

3.3 Budget neutrality

It is preferable to develop a revenue-neutral carbon price mechanism where revenue is used to fund green innovations and to compensate both households and businesses.[36] As discussed previously, the revenue from the carbon price policy will be utilised to compensate low-income households and businesses. In addition, the revenue will be used for transition relief for displaced workers (such as miners), supporting energy research and development, and encouraging conservation activities.[37]

Both the transitional carbon price scheme and future ETS will generate considerable revenue and it is rational to apply the revenue-neutrality principal to the design of the policy.[38] A major tax reform involving an increase in the tax-free threshold is essential

[34] Professor Brook (2009, above note 16, p. 9), criticising the ACPRS proposed by the Australian government, argued that: 'An emissions cap and trade approach provides no certainty in price where emissions will need to be reduced (more than the 5% that might happen with recession anyway). There is a risk that with an artificial price cap, the ceiling might be reached and businesses will run out of permits. At that stage we will face an impossible economic dilemma and the government will need to choose between acknowledging that the CPRS didn't work or it might force business sectors into closure. The claim that it is difficult for a carbon tax approach to manage uncertainty around future carbon price is by definition untrue because it is far more direct, transparent and can be more easily forecast.'

[35] A price ceiling and floor will apply for the first three years of the flexible price period. The ceiling will be set at $20 above the expected international price and will rise by 5 per cent in real terms each year. The price floor will be $15, rising annually by 4 per cent in real terms (Multi-Party Climate Change Committee, above note 7).

[36] The Committee suggests that the policy should be budget-neutral but this does not preclude other climate change measures being funded from the Budget.

[37] Multi-Party Climate Change Committee, above note 7.

[38] Bosquet, B. 2000. Environmental Tax Reform: Does it Work? A Survey of the Empirical Evidence. *Ecological Economics*, 34, 19-32, p. 19; EEA. 2005. *Market-based Instruments for Environmental*

to compensate many low-income families who would otherwise be severely affected. However, industry assistance of $9.2 billion over the period 2014–15 is arguably too generous. Overall, the proposed legislation is not budget neutral because there will be $3.961 billion gap from 2011–12 to 2014–15 in funding needed from the budget for the programs proposed.[39] In addition, there will be an unknown cost to shut down the most polluting power stations. Another issue is a potential sharp fall in the Australian carbon price when emissions trading starts in 2015.[40] This would produce an additional pressure on the federal budget. For example, if the carbon price fell to $15 a tonne when the emissions trading scheme starts in 2015, the call on the budget would be some $3 billion annually from 2015–16 to 2019–20.[41] In this light it is reasonable to conclude that the proposed legislation in its present status is unlikely to be budget neutral.

3.4 Competitiveness of Australian industries

It is well established that the higher production costs caused by carbon policies affect the international and sectoral competitiveness of firms.[42] The concern for international competitiveness generates strong opposition to GHG reduction policy. In the case of Australia, the concerns for the competitiveness of export and energy-intensive industries represent a real political hurdle. Energy generators and energy-intensive industries, such as the steel and chemical industries, are the most disadvantaged by GHG reduction policies.[43] These industries exercise a political power that is sufficient to influence the implementation of carbon pricing in Australia. This is despite the fact that a preliminary examination of the impact of the ACPRS on Australia's ASX100[44] companies indicated that for approximately 75 per cent of companies the impact would be less than 2 per cent of value, and in most cases, below 1 per cent of value if a carbon price is $20 tonne.[45] Nonetheless, the literature and experience indicate that it

Policy in Europe. Technical report 8. European Environmental Agency. Available: http://www.eea.europa.eu/publications/technical_report_2005_8.

[39] Carbon Pollution Reduction Scheme and Carbon Pricing Mechanism: comparison of selected features, above note 20.

[40] The Business Council of Australia, Submission to the Joint Select Committee Inquiry into Australia's Clean Energy Future. Available at: http://www.bca.com.au/Content/99521.aspx

[41] Ibid.

[42] See for example: OECD. 2003a. Environmental Taxes and Competitiveness: An Overview of Issues, Policy Options, and Research Needs. Available: www.olis.oecd.org/olis/2001doc.nsf/LinkTo/com-env-epoc-daffe-cfa(2001)90-final (Accessed 04/09/2009).OECD. 2008. Environmentally Related Taxes and Tradable Permit Systems in Practice. Centre for Tax Policy and Administration. Available: http://www.oecd.org/department/0,3355,en_2649_34295_1_1_1_1_1,00.html (Accessed 29/08/2009).

[43] Garnaut, R. 2008. *Garnaut Climate Change Review*. Available: http://www.garnautreview.org.au/domino/Web_Notes/Garnaut/garnautweb.nsf (Accessed 21/11/2011).

[44] The ASX 100 index is Australia's premier large capitalisation equity index. It is comprised of 100 stocks selected by the Standard & Poor's Australian Index Committee.

[45] In particular, this report suggests that for the mining industry, a reduction in value would be 0.5–1.5 per cent; for paper, steel, cement, mineral sands and aluminium industries the impact would be 0.57 per cent. (Climate Institute 2008. Submissions to the Carbon Pollution Reduction Scheme Green Paper. *The Climate Institute.* Canberra., p. 15.) However, some industries such as LNG and a number of chemical companies could benefit from stronger demand generated by GHG reduction policy. For example, AGL profits might increase by almost $150 million (at $20 a tonne of carbon), and by in excess of $200 million if a carbon price would be $40 a tonne. (Parkinson, G. 2008. *Time for a Renewable Vision*. Available: http://www.businessspectator.com.au/bs.nsf/Article/Time-to-stop-backing-fossils-HR6CS?OpenDocument).

is necessary to alleviate or compensate the losses of businesses, to distribute the costs more evenly and to enhance the political feasibility of a GHG reduction policy. The compensation measures are clearly one of the most influential factors associated with competitiveness issues.

Despite providing generous compensation for businesses, the carbon price mechanism and future ETS differ in some characteristics influencing the competitiveness of businesses. An ETS will be endowed with an international linkage mechanism[46] which provides an extra opportunity for businesses to meet their liability under the scheme. Certain types of internationally recognised permits may be used to acquit up to 50 per cent of an entity's liability when emissions trading starts.[47] With such generous linkage, the price of Australian permits will depend on international carbon markets. A linkage mechanism will directly affect domestic action and, as a result, an Australian national emissions target would be achieved with a small real reduction of Australia's GHG. Therefore, whilst linking is a useful provision offering extra opportunity to the participants, it must be restricted to supplementing domestic reduction. The amount of international emissions units surrendered by business should be limited to no more than 10 per cent of the total permits surrendered.[48] In this way, the Australian carbon price will be isolated from the influence of international carbon price and domestic reduction will not be jeopardised.

The proposed legislation renders extensive assistance packages to affected industries, thus considerably reducing competitiveness concerns. Additionally, a generous international linkage mechanism provides extra opportunities for businesses to meet their obligations.

3.5 Energy security

Energy security is an increasingly important element of Australia's security policy agenda.[49] Australia is one of the world's largest exporters of coal and uranium, and therefore at present, Australia's position in the global energy market appears to be confident.[50] However, to increase energy security, Australia should diversify its energy sources. Future technological development can help to reduce the emissions intensity of the economy and to meet the challenge of energy security in the long term.

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[46] Generally, an international linkage mechanism offers companies covered by the ETS the opportunity of investing in emissions reduction projects in developing countries such as those in China, and bringing carbon credits back to use in the domestic ETS. Therefore, companies can use credits from the Kyoto Protocol mechanisms to fulfil their obligations under the ETS. Such international linkage undeniably provides an additional flexibility for the participants. For example, the EU ETS provides similar arrangement for the participants.

[47] International linking has been substantially criticised see for example: Jaffe, J. and R. N. Stavins. "Linkage of Tradable Permit Systems in International Climate Policy Architecture." Discussion Paper 08-07, Harvard Project on International Climate Agreements, Belfer Center for Science and International Affairs, Harvard Kennedy School, September 2008.

[48] Jaffe J. and Stavins R. 2007. Linking Tradable Permit Systems for Greenhouse Gas Emissions: Opportunities, Implications, and Challenges. International Emissions Trading Association, published at United Nations Climate Change Conference COP13/CMP3, Bali.

[49] National Energy Security Assessment December 2011. Commonwealth of Australia.

[50] Australia's Energy Production, Consumption and Exports. Available at: http://www.ga.gov.au/energy/basics.html

Reportedly, Australia trails behind other OECD countries in energy efficiency advancement, while there are many opportunities to upgrade energy efficiency.[51] Policies to improve energy efficiency need to be developed to address specific market failures. Otherwise, these non-price market failures will raise the cost of meeting a GHG reduction target to the economy. Additionally, improving energy efficiency can significantly lower households' exposure to rising energy prices.[52] A number of analysts recommend targeting technology development directly, specifically by introducing measures aimed at stimulating research.[53]

The Australian government proposed a number of critical complementary policies to support climate change mitigation efforts, including: energy efficiency information, the low income energy efficiency program, a household energy and financial sustainability scheme, the Remote Indigenous Energy Program, the Tax Breaks for Green Buildings Program, and the Energy Affordability Scheme, amongst other programs.[54] Moreover, substantial funds are dedicated for research and development including the aforementioned Clean Energy Finance Corporation, Australian Renewable Energy Agency, $200 million over five years for grants to support business investment in research and development in renewable energy, low-pollution technology and energy efficiency. In addition, a range of existing programs to support clean energy innovation will be continued with committed funding of over $2 billion.[55] Undeniably, these initiatives and funding are needed for successful development of green technologies and therefore should supplement the GHG reduction policy.

Nonetheless, in addition to the aforementioned green initiatives, a broad-scale feed-in-tariff (FIT) which would replace all state-level FIT schemes[56] and apply to all renewable energy generators, needs to be implemented in Australia.[57] Overall, these measures may have dissimilar effects during the fixed price period and future emissions trading but such effects are difficult to forecast. For the purpose of this analysis, it is assumed that the supplementary measures proposed to be included in the carbon policy package are likely to increase Australian energy security.

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[51] IEA 2008. Worldwide Trends in Energy Use and Efficiency: Key Insights from IEA Indicator Analysis. International Energy Agency, Report to G8. Paris.

[52] Aldy et al. 2009, above note 28.

[53] Some analysts argue that it is necessary to address each market failure with separate policy instruments. See, for example; Daily, G. C. & Ellison, K. 2002. *The New Economy of Nature: The Quest to Make Conservation Profitable*, Washington DC, Island Press; Fischer, C. & Newell, R. G. 2007. Environmental and Technology Policies for Climate Mitigation. *Resources for the Future, Discussion Paper 04-05*. Washington DC.

[54] For details see: Carbon Pollution Reduction Scheme and Carbon Pricing Mechanism: comparison of selected features, above note 20.

[55] Ibid.

[56] Energy Matters. Available at: http://www.energymatters.com.au/government-rebates/feedintariff.php#fit-table

[57] Since solar and wind energy is generally more expensive than energy produced through burning of fossil fuels, renewable energy needs to be subsidised to encourage its production. FIT is a rate paid to producers of renewable energy, or in other words, it is a way of subsidising renewable energy.

3.6 Investment certainty

Investment confidence is critically important for the development and deployment of new, energy efficient and clean technologies in Australia and worldwide. In this context, the predictability or regulatory certainty of GHG reduction policy is a significant aspect influencing future investments. Considerable investment from the private sector is required to stimulate the progress and implementation of green technologies. Evidently, such investments depend on the predictability of GHG reduction policy.

Predictability and certainty of a climate change policy significantly depends on the certainty of a GHG reduction target. A first element of predictability that the government should announce is unambiguous GHG reduction targets which would enable planning by businesses of their investments and other activities. This precondition would facilitate the initial credibility of the climate change policy. As discussed previously, the element of certainty in reduction targets is integrated into the considered carbon policy. However, it is worth noting that the government aims to establish the caps on emissions for the first five years of the ETS in 2014.[58] Investment decisions require full information on carbon caps well in advance but unfortunately, this is not the case under Australian carbon policy.

Another important precondition of policy predictability is carbon price certainty. The long-term predictability of input prices is vital for investors and technological development. However, as noted earlier, there is a fundamental problem with a flexible carbon price. For the fixed price period in the first three years, the price will be $23 in 2012–13, $24.15 in 2013–14 and $25.40 in 2014–15 per ton of CO2.[59] A fixed carbon price is able to convey a certain price signal to industry and consumers whereas an ETS price signal entails less certainty. The EU ETS current price is around EUR8 and the Certified Emission Reduction (CER) price is around EUR4. Thus, if emissions trading starts today, the Australian carbon price is likely to slip to $10–$15.[60] The operation of the $15 floor prices, when international units are traded well below $15, is blurred. Under this scenario, liable businesses may buy international carbon units for 50 per cent of the requirement and the demand for the domestic carbon units will be very depressed, resulting in low prices. The emissions price volatility associated with emissions trading would significantly affect investment certainty.

Presumably, even relatively stable political regimes like Australia cannot guarantee the predictability of such a long term policy as climate change. Even if a government will guarantee predictability of either carbon price mechanism or ETS, there would still be uncertainty in the long-term as a new political party may come to power and change the policy or the policy may need to be updated due to new information. This is especially true considering that the opposition leader, Tony Abbot, has promised to

[58] If the parliament rejects the regulations presented in 2014, the mechanism will automatically allow for a pre-prescribed pollution cap to come into effect for the first flexible price year only.
[59] Multi-Party Climate Change Committee, above note 7.
[60] The prices are current at 22/03/2012. Available at: http://www.pointcarbon.com/

repeal the carbon price legislation if he comes to power.[61] Therefore, it is clear that some element of legislative uncertainty will remain in any case. Overall, the carbon price and the ETS might provide some investment certainty. Nevertheless, the carbon price will be known in advance and would be more stable, while the ETS price stability is highly questionable. The uncertainty in price and emissions caps associated with the ETS decisively diminishes the credibility of this instrument. Thus, it is justifiable to suggest that the policy, particularly future ETS, proposed by the Australian government would not facilitate an adequate level of investment certainty.

3.7 Fairness

Generally, the literature indicates that distributional concerns are deemed to occur when a carbon tax or an ETS are introduced.[62] The negative distributional impact across households is a major issue for governments introducing climate change policies and the Australian government is no exception.

The impacts of carbon taxes and an ETS significantly depend on the revenue's utilisation. If the revenue is recycled in a proper way – in favour of low-income or disadvantaged groups – the adverse distributional effect can be neutralised substantially or completely, or even reversed, depending on the recycling scheme.[63] Another aspect of revenue recycling affecting households, especially in long term, is energy efficiency measures and research and development (R&D) funding. If part of the revenue is spent for these purposes, new green technologies and the energy efficiency measures available to households would facilitate a reduction in the distributional burden.[64]

It is compulsory to consider incorporating measures for compensating the unfavourable distributional effects when designing a new GHG reduction policy. As mentioned above, the Australian government is allocating part of the revenue from the carbon price scheme to increase the tax-free threshold and to expand welfare programs for low-income households.[65] Additionally, a significant part of carbon policy revenue is also dedicated to energy efficiency and R&D measures. Thus, it is reasonable to conclude that the proposed carbon policy is able to address this principal.

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[61] Tony Abbott promises to get rid of carbon pricing scheme within six months of being elected to power. Available at: http://www.news.com.au/national-old/tony-abbott-promises-to-get-rid-of-carbon-pricing-scheme-within-six-months-of-being-elected-to-power/story-e6frfkw9-1226334281970

[62] Ekins, P. & Dresner, S. 2004. *Green Taxes and Charges: Reducing Their Impact on Low-Income Households*. York. Available: http://www.jrf.org.uk/bookshop/eBooks/1859352472.pdf; EEA. 2005. *Market-based Instruments for Environmental Policy in Europe. Technical report 8*. European Environmental Agency. Available at: http://www.eea.europa.eu/publications/technical_report_2005_8

[63] Ibid.

[64] Ibid.

[65] For example, according to the government, the average household will see cost increases of around $9.90 per week, while the average assistance provided will be around $10.10 per week. Carbon Pollution Reduction Scheme and Carbon Pricing Mechanism: comparison of selected features, above note 16.

3.8 Flexibility

According to the Committee, a carbon price mechanism needs to be flexible to respond to changing international circumstances and new information on climate change. Indeed, the flexibility of the policy is especially vital in the context of climate change. In some areas of policy making, flexibility might not be a critical criterion for effective performance of policy. In the case of climate change – the consequences of which are decidedly uncertain and very difficult to predict – the degree of flexibility of the policy required to reflect new information must be reasonably high. Flexibility allows governments to respond to future uncertainties.[66]

It is generally agreed that uncertainty about climate change will not be resolved soon but new information is likely to occur regularly; hence, it is important to maintain flexibility.[67] In general terms, if the carbon price is too severe it could be fairly simply decreased. If the carbon price does not provide genuine GHG reduction it could be increased. Either way, the carbon price may be adjusted on the basis of new scientific or economic data. Such amendments might be made on a regular basis, thus facilitating predictability and allowing a constant review of the effectiveness of the scheme.

It might be argued that the ETS is less straightforward in this context. Since emissions permits represent significant financial value, it is more difficult to adjust emissions trading. If, for example, permits are auctioned but the reduction target needs to be enhanced, it may be challenging to buy the permits back from the participants. Conversely, such a problem would not appear under the carbon price approach which lacks financial assets (emissions permits).

Goulder and Parry[68] suggest that an ETS with banking and borrowing provisions[69] might be somewhat more advantageous in respect of flexibility than a carbon tax. They suppose that if new information came through necessitating a constriction in the reduction target, the price can be attuned automatically under an ETS. Participants and traders would expect more stringent reduction targets and, therefore, present and anticipated future permit prices would increase ahead of an actual adjustment to GHG emissions reduction targets.[70] They maintain that, if new data would occur under a carbon tax, the legislative adjustment of the tax rate might take some time. The market may provide the ETS with an additional mechanism increasing flexibility. Thus, implied sensitivity to changes is an advantage increasing the flexibility of the ETS policy but not associated with the carbon price mechanism.

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[66] Anda, J., Golub, A. & Strukova, E. 2009. Economics of Climate Change under Uncertainty: Benefits of Flexibility. *Energy Policy*, 37, 1345–1355.

[67] Garnaut 2008, above note 43, Anda et al. 2009, above note 66.

[68] Goulder, L. H. & Parry, I. 2008. Instrument Choice in Environmental Policy. *Resources for the Future, Discussion Paper 08-07*. Washington DC.

[69] Banking and borrowing – by allowing participants to bank permits when permit prices are low and borrow permits from future periods when prices are high, price volatility under an ETS can be controlled to some extent.

[70] Goulder and Parry 2008 above note 68.

Indeed, the market may react faster than the government to the changing situation, but under tax and ETS, the reduction target would need to be adjusted legitimately, which might be equally complicated and time consuming under both regimes.[71] The actual legislative adjustment of a regime would depend on many factors, such as the design of a regime, bureaucracy, and parliamentary acceptance, amongst many others. The regime considered in this paper is theoretically flexible. The ETS emissions caps can be reassessed in the same way as the carbon price may be updated on a regular basis with regard to the latest scientific information. However, legislative adjustment of the regime – especially the enhancement of the reduction target – is unlikely to be easy.

3.9 Administrative simplicity

The Committee suggests that a carbon price mechanism should be designed to minimise compliance costs and implementation risks. Compliance costs are often analysed in conjunction with administrative costs that are borne by the government.[72] The compliance and administrative costs issue is generally well recognised in various fields of public policy, but since climate change policy is relatively new, there has been little attempt to estimate these costs.[73]

Generally, analysts are inclined to agree that carbon taxes are likely to be organisationally simpler than an ETS. There is also some literature investigating the compliance costs of an ETS. For example, Kerr and Mare,[74] in their study of transaction costs[75] in the US-led credit trading scheme, find that transaction cost effects are sufficiently strong to decrease the total achieved gain from trade by 10 to 20 per cent.[76] There were also some estimates of compliance costs related to the EU ETS.77 However, the EU ETS is applied middle-stream, thus covering a number of businesses. An upstream ETS or carbon price would apply to a significantly smaller

[71] Quiggin, analysing uncertainty and climate change policy, notes in this respect: "(t)here is unlikely to be much difficulty in maintaining flexibility to relax mitigation policy if the problem of climate change turns out to be less serious than the current median estimate. Governments can cut taxes on carbon, give away additional emissions permits and relax regulatory constraints, all of which will generally be popular moves. It will be rather more difficult to maintain the flexibility to move to more aggressive mitigation policies than are contemplated in initial agreements." (Quiggin, J. 2008. Uncertainty and Climate Change Policy. *Economic Analysis & Policy*, 38, 203-210., p. 209).

[72] Some researchers have a tendency to unite administrative and compliance costs under the term 'operating costs' see for example: Pope, J. & Owen, A. D. 2009. Carbon Emission Taxes: Potential Revenue Effects, Compliance Costs and Overall Tax Policy Issues. *Australasian Tax Teachers Association Conference.* Christchurch.

[73] Ibid.

[74] Kerr, S. & Mare, D. 1998. *Transaction Costs and Tradable Permits. The United States Lead Phasedown*. Available: http://www.motu.org.nz/pdf/transaction_costs.pdf., p. 3.

[75] Generally, economists tend to consider transaction costs as costs incurred by businesses covered by a policy, thus separating these costs from the administrative costs borne by government.

[76] It is noted that the losses from transaction costs were considerable for some companies, especially smaller businesses. Kerr and Mare conclude that transaction costs, in fact, reduce the efficiency savings of an ETS (Kerr & Mare 1998 above note 74).

[77] For example, research by the UK Emissions Trading Group (ETG) based on a survey of its members assessed these costs as totalling up to £68 million for UK businesses participating in Phase 1. That is quite significant considering that the EU ETS covers less than 50 per cent of GHG emissions. Moreover, the research estimates compliance costs for Phase II of the EU ETS at more than £100 million over the duration of the scheme. Riddell, N. 2008. Administrative Cost of the Emissions Trading Scheme to Participants. *The UK Emissions Trading Group, Working Group 5/6 Study.* London.

number of businesses, implying lower compliance costs associated with the policy. Pope and Owen estimated that the operating costs of the ACPRS will be around AU$200 million annually.[78] They also note that there will be additional start-up costs roughly estimated at about one year of operating costs (AU$200 million). Pope and Owen suggest that, since the ACPRS will cover about 1,000 emitters, aggregate compliance costs for the participants are likely to be moderate.[79] Indeed, compliance costs associated with the ACPRS may not seem to be drastic, but if we were to compare it with compliance costs under a carbon tax, the conclusion might be different.[80]

The considered carbon policy is applied upstream and hence the policy minimises compliance costs in this respect. However, the more complex the climate change policy, the more cost it would involve to comply for covered businesses. An ETS, complex-by-nature, entails significant associated costs, such as fees paid to brokers or exchange institutions to find trading partners, negotiating costs, insurance costs and so forth. An ETS requires the creation of a new market mechanism, government body and certain new arrangements from businesses.[81] Overall, compliance costs for businesses under an ETS may be comparably high.

Resembling the logic of compliance costs, the simplicity of the policy is significant for the minimisation of administrative costs. Pope and Owen, analysing the potential operating costs, suggested that the government should establish a new independent body to manage ACPRS. However, their estimation appears to be too optimistic.[82] The government has established a range of bodies to manage various climate policy related issues.[83] For example:

- The Climate Change Authority established as an independent body to review key aspects of the carbon price mechanism and the government's climate change mitigation initiatives.

[78] Pope and Owen 2009, above note 72, p. 16.
[79] Ibid.
[80] Tax is not as novel an instrument as an ETS and it does not require any new arrangements from the participants. Carbon tax involves little costs, over all stages of their life span, because a tax could be paid through the current tax infrastructure.
[81] Many commentators agree that emissions trading usually requires new institutions (regulatory bodies). See, for example: Quiggin, J. & Gans, J. 2007. *Submission to the Prime Ministerial Task Group on Emissions Trading*. Available: http://docs.google.com/View?docid=dc8dmjgw_6d967zm; Humphreys (2007); Metcalf, G. E., Palstev, S., Reilly, J., Jacoby, H. & Holak, J. 2008. Analysis of U.S. Greenhouse Gas Tax Proposals. MIT Joint Program on the Science and Policy of Global Change. Cambridge.
[82] For example, Humphreys, discussing the compliance costs associated with a potential Australian ETS, argues: "Many of these costs of trading are already apparent in other trading systems, such as the EU carbon trading system and the Australian taxi-licensing system. Taxi licences have been slow to adjust to changing conditions (resulting in a poor and prohibitively expensive service), have created a wasteful artificial market in licences that benefits licence traders but not the government or the economy, involves administrative and compliance costs, and has been notoriously difficult to reform." (Humphreys, J. 2007. Exploring a Carbon Tax for Australia. *Centre for Independent Studies, Perspectives on Tax Reform 14.* St Leonards., p.4.)
[83] Clean Energy Agreement. Available at: http://www.climatechange.gov.au/government/initiatives/mpccc/resources/clean-energy-agreement.aspx

- An independent regulator (the Clean Energy Regulator) established to administer the carbon price mechanism within a limited and legislatively prescribed discretion.
- The Clean Energy Finance Corporation (CEFC) established to support projects using a range of funding tools: loans on commercial or concessional terms, loan guarantees or equity investments ($10 billion).
- The Australian Renewable Energy Agency (ARENA) is a Commonwealth Authority established under the Commonwealth Authorities and Companies Act (CAC Act). ARENA will have independent governance of $3.2 billion in existing government support for R&D, demonstration and commercialisation of renewable energy technologies.
- An independent Land Sector Carbon and Biodiversity Advisory Board established by legislation to review and oversee land sector initiatives, including those related to abatement and biodiversity.

In this light, it seems that the administrative and compliance costs of the carbon pricing regime might be relatively high. Overall, this implies a number of new arrangements and complex rules which increase the administrative complexity of the policy.

3.10 Clear accountabilities

The Committee suggested that a carbon price mechanism should have transparent rules and clear accountabilities to promote business and community confidence. The transparency and accountability principle is often undermined by policy makers. The transparency of a policy is vital to support environmentally effective objectives, lower the overall costs of GHG reduction and to build a reliable foundation for decision-making. Transparency plays a key role in many aspects of climate change policy[84] and is often cited as the primary argument for a carbon tax.[85] Transparency of the policy can strengthen democracy, increase trust in government, lead to legitimacy, credibility, and enhance public education, all of which is important.[86] An ETS by definition is less transparent and a more multifaceted policy than a carbon tax. As noted above, an ETS requires complex and broad legislation that is not simple to

[84] For example, the EU ETS directive provides that the NAP must go through a mandatory public participation process to maximise transparency of the policy. GHG reduction policy legislation and procedures must be maximally transparent, otherwise the stakeholder participation procedure will become obsolete and thus the public acceptability of the policy will be uncertain. (Matthes, F., Graichen, V. & Repenning, J. 2005. *The Environmental Effectiveness and Economic Efficiency of the European Union Emissions Trading Scheme: Structural Aspects of Allocation*. Available at: http://www.wwf.de/imperia/md/content/klima/2005_11_08_full_final__koinstitut.pdf).

[85] Broad literature suggests that a carbon tax is transparent and easy to understand for the public. See: Shapiro, R. 2007. Addressing the Risks of Climate Change: The Environmental Effectiveness and Economic Efficiency of Emissions Caps and Tradable Permits, Compared to Carbon Taxes. Available: http://www.sonecon.com/docs/studies/climate_021407.pdf; Freebairn, J. 2008. Taxes or Tradable Permits to Reduce Greenhouse Gas Emissions. *Musgrave Symposium, June 2008.* Sydney.

[86] Renn, O. 2004. The Challenge of Integrating Deliberation and Expertise: Participation and Discourse in Risk Management. *In:* Macdaniels, T. L. & Small, M. J. (eds.) *Risk Analysis and Society: An Interdisciplinary Characterization of the Field.* Cambridge: Cambridge University Press.

comprehend for the public and businesses. Professor Mann[87] vividly summarises this problem:

> The complexity of a cap-and-trade system makes it difficult for taxpayers and consumers to determine who will be paying the costs, and how much those costs will be. The complexity allows affected industries to jockey for advantage and exemptions without the general public understanding what is going on. From an end-user cost perspective, a carbon cap-and-trade system is opaque, not transparent. This may be viewed as a political advantage – if consumers don't understand that some industries are getting off without paying their fair share, it is unlikely that consumers will raise objections. Political compromises can then be made among the industries without fear of public uproar.

Transparency benefits the industries bearing the burden of a carbon price, since it may facilitate price certainty.[88] As discussed earlier, a carbon price set through a fixed price mechanism similar to a tax will not fluctuate with the market, thus providing transparent and certain costs required for businesses' investment decisions. Additionally, such a mechanism is transparent in terms of openness for the public and businesses because it can be simply levied per tonne of carbon content of fuel, per kWh of electricity or litre of petrol, and is therefore easy to understand. The ETS, on the other hand, requires a market structure and other arrangements which are evidently more complex mechanisms and thus less transparent than a straightforward fixed carbon price. Therefore, it is reasonable to conclude that while the carbon price mechanism provides a certain level of transparency and accountability, a future ETS would involve some uncertainty and complications – hence the overall ability of Australian carbon policy to address this principle is rather limited.

3.11 Supports Australia's international objectives and obligations

To support Australia's international objectives and obligations, a carbon pricing mechanism should have a capacity for international harmonisation. The Australian government tends to prioritise international harmonisation of climate change policies.[89]

Many analysts agree that an ETS is much easier to harmonise with other countries' carbon mitigation programs.[90] Indeed, an ETS generates a natural unit of exchange for harmonisation: permits denominated in units of GHG emissions. Since the costs associated with climate change (e.g. coastal flooding, crop loss, etc.) have no connection with the source of GHG emissions, the rationale for ETS global harmonisation is understandable. If emissions reductions are cheaper to make in China than in Australia, emissions ought to be reduced first in the former where costs are

[87] Mann, R. 2008. Crouching Lobbyist, Hidden Subsidy? How to Overcome Politics and Find Our Green Destiny. *The Ninth Annual Global Conference on Environmental Taxation*. Singapore., p. 17.
[88] Shapiro 2007, above note 85; Freebairn 2008, above note 85.
[89] See for example: Multi-Party Climate Change Committee, above note 7.
[90] See: Green et al., above note 33; Garnaut 2008, above note 43.

lower.[91] Thus, a universal exchange unit is critically important for the international harmonisation of climate change policies around the globe. While the ETS is naturally equipped with such a unit, GHG reductions under the carbon tax are not easily transferable to a particular exchange unit. Besides, existing international Kyoto units are well suited for the ETS, whereas there is no similar arrangement for the carbon tax.

Furthermore, due to certainty in emissions targets, an ETS is more conducive to international environmental agreements, such as the Kyoto Protocol. Generally, emissions reduction targets can be settled more easily than, for example, tax rates.[92] In reality, the countries would have to find a compromise regarding tax base, tax rate, and treatment of other taxes and/or subsidies that influence the effective burden of a carbon tax. The Australian government, in proposing the ACPRS, also argues that harmonisation of carbon taxes will require multi-national agreement which is difficult to achieve in practice.[93] This argument seems to be logical but it has not been proven in practice.[94] For example, the EU ETS is linked with the Kyoto Protocol flexible mechanisms but it is not harmonised with other schemes.[95] Certainly, there are few other ETSs in the world but, more importantly, the economic conditions in various countries (especially developed and developing countries) differ considerably which makes it difficult to harmonise national ETSs.[96] Nonetheless, certain quantitative GHG reduction targets associated with the ETS can potentially be more naturally harmonised than such a sensitive issue as tax rates.

The present practical trend is that more and more governments are introducing and proposing emissions trading which adds further to its possible harmonisation.[97] Since major economies tend to propose and implement an ETS rather than carbon tax to reduce GHG emissions, many other countries are likely to follow suit.[98] Thus, the

[91] Stavins, R. 2007. Proposal for a U.S. Cap-and-Trade System to Address Global Climate Change: A Sensible and Practical Approach to Reduce Greenhouse Gas Emissions. *The Brookings Institution.* Washington DC.

[92] Shapiro (2007, above note 85) suggests that despite a carbon tax having environmental and economic advantages over an ETS, an international harmonisation of carbon taxes would be rather difficult. See also, Stavins 2007, above note 91; Garnaut 2008 above note 43.

[93] CPRS 2009, above note 3.

[94] Professor Brook (2009, above note 16, p. 8), criticising emissions trading proposed by the Australian government, notes in this context: 'The reality check needed here is that harmonisation is not likely to occur in either case because even if all nations could participate in the market, nations have different economic wealth. We don't have free trade and market parity in any other aspect of global markets so it is a fallacy to suggest that carbon prices will equalise across nations regardless of whether there is a carbon tax or a cap and trade approach, particularly when we need action from both developed and developing nations.'

[95] Although, the experience of the EU ETS demonstrates that linking of emissions trading with the Kyoto mechanisms provides an additional abatement option for the participants. This provides evident incentive for the governments around the world to consider an ETS rather than carbon tax as a national climate change policy.

[96] Brook 2009, above note 16.

[97] See: Status of Global Mitigation Action. Available at: http://www.climatechange.gov.au/en/government/initiatives/multi-party-committee/resources.aspx.

[98] Garnaut (2008, above note 43, p. 311) states in this context: 'Australian mitigation policy needs to be considered in the international context of action and commitments. The world is now some way down the track towards an international system based on emissions reduction targets, starting with developed countries. Regulatory approaches, carbon taxes, hybrid schemes and baseline and credit schemes would

influence of international trends in climate change policy is another factor in favour of the ETS. Overall, a large amount of theoretical literature as well as the above discussion gives priority to the ETS in respect of international harmonisation. Therefore, the considered carbon policy, especially future ETS, implies a strong case to support efficiently Australia's international objectives and obligations.

4. OVERALL ASSESSMENT

On the whole, the examination of the Australian carbon policy capability implies the following results:

Principles (criteria)	Comments	Provisional Assessment
Environmental effectiveness	Under present settings it is unlikely that the proposed carbon policy would address this criterion.	Fundamentally flawed
Economic efficiency	The design defects of the considered policy may significantly reduce its economic efficiency.	Flawed
Budget neutrality	In its present status, the introduced policy is unlikely to be budget neutral.	Flawed
Competitiveness of Australian industries	The carbon policy renders an extensive assistance package to affected industries and, in three years, will provide generous international linkage, thus considerably reducing competitiveness concerns.	Supported
Energy security	Supplementary measures included in the carbon policy package are likely to increase Australian energy security.	Supported
Investment certainty	The price uncertainty associated with the ETS as well as general legislative volatility significantly reduces investment certainty of the carbon policy.	Flawed

not be readily integrated with existing and emerging international arrangements that could provide Australia with lower-cost mitigation opportunities.'

Fairness	Since a significant part of carbon policy revenue is dedicated to low-income households and energy efficiency as well as R&D measures, this principle is addressed.	Supported
Flexibility	The proposed policy provides certain degree of flexibility but the legislative adjustment of the policy may prove to be difficult.	Flawed
Administrative simplicity	The policy package has a number of measures which imply complicated rules and require the creation of new institutions thus eroding the administrative simplicity principle.	Flawed
Clear accountabilities	The considered policy is implicitly complex and non-transparent; hence it is unlikely to address this principle.	Flawed
Supports Australia's international objectives and obligations	The policy design is well suited to reflect this criterion.	Supported

Overall, the above analysis demonstrates that the present policy designed by the Australian government fails to address a number of the critical principles outlined by the Multi-Party Climate Change Committee, particularly; environmental effectiveness, economic efficiency, investment certainty, administrative simplicity and clear accountabilities. The criteria that the carbon policy sustains well are competitiveness of Australian industries, fairness and Australia's international objectives and obligations, which seems to be prioritised by politicians. As a result, the introduced carbon policy contradicts some of the critical principles which were meant to be addressed in the first place. In this light, it is reasonable to conclude that the Australian government should revise some of the vital aspects of the proposed carbon policy. For example, it is necessary to increase the GHG reduction target, expand the coverage of the policy and reconsider the international linkage mechanism. There are certainly many more gaps to be addressed in the Australian carbon policy framework but they were well discussed elsewhere.

5. CONCLUSION

This article has assessed the recently introduced Australian carbon policy on the basis of the principles outlined by the Multi-Party Climate Change Committee. The policy was examined with particular reference to the relevant contemporary literature, existing practices and empirical studies. Generally, the introduced carbon policy mechanism is capable of providing a carbon price signal. On the other hand, it is an obscure and complicated policy that is characteristic for an ETS. The policy nonetheless has some advantages – specifically, support for international action, which is being constantly delayed.

The conclusion of this analysis is that the present carbon pricing regime is 'a curate's egg' and hence it must be substantially revised, intimately addressing the critical principles distinguished by the Multi-Party Climate Change Committee that would allow Australia to develop a more effective and sustained carbon policy solution.

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Land taxation: a New Zealand perspective

Jonathan Barrett and John Veal*

Abstract
This article considers land taxation from a New Zealand perspective. The theory underpinning land taxation is first sketched, along with the legislative history of land taxation in New Zealand and contemporary local arrangements. Generally accepted tax criteria are then applied to land tax proposals; other relevant concerns are also considered. It is concluded that, as a substitute for capital gains tax, which New Zealand does not current levy, a national land tax has little to offer but, as a radical alternative to income tax, a national land value tax deserves greater consideration.

1. INTRODUCTION

Land taxes have a long theoretical pedigree and, historically, a particular resonance in Australasia. Australia enacted a federal land tax in 1910 that coexisted with State land taxes until 1952.[1] Currently, save for the Northern Territory, land taxes are levied at a State level; local council rates are also charged.[2] New Zealand introduced a national land tax in 1878 that was not repealed until 1992.[3] Currently, only local authorities levy land taxes.[4] While land taxes at a sub-national level are considered 'natural', they have fallen out of favour as national taxes in Australasia. However, in 2010, New Zealand's Tax Working Group recommended a national land tax,[5] as have international agencies.[6] Why has there been a resurgence of interest in a tax that was considered obsolete long before its abolition?

First, it is widely accepted that government measures are needed among Organisation of Economic Cooperation and Development (OECD) member countries to mitigate inequality.[7] Inequality in New Zealand has increased since the land tax was

* School of Business, Open Polytechnic, New Zealand. Contact: Jonathan.barrett@openpolytechnic.ac.nz or john.veal@openpolytechnic.ac.nz.

[1] See the *Land Tax Assessment Act 1910* (Cth) and the *Land Tax Abolition Act 1952* (Cth). For a historical analysis of land taxes in Australia, see Cynthia Coleman and Margaret McKerchar, 'The History of Land Tax in Australia' in John Tiley (ed), *Studies in the History of Tax Law, 4* (Hart Publishing, 2010) 281, 281-295. There is no constitutional impediment to a federal land tax; the reservation of land taxation to the States in the 1950s was driven by practical considerations. Ibid.

[2] See *Land Tax Act 2004* (ACT); *Land Tax Act 1956* (NSW); *Land Tax Act 2010* (Qld); *Land Tax Act 1936* (SA); *Land Tax Act 2000* (Tas); *Land Tax Act 2005* (Vic); *Land Tax Act 2002* (WA); and sundry local government Acts.

[3] See 2.2 below on the legislative history of land taxes in New Zealand.

[4] See 2.3 below on the rating system in New Zealand.

[5] Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2010) ('Tax Working Group').

[6] See, for example, International Monetary Fund, *New Zealand: 2011 Article IV Consultation* (International Monetary Fund, 2011) 14.

[7] See, generally, Angel Gurría 'Tackling Inequality' (2011) 287 (Q4) *OECD Observer* 3.

abolished;[8] a national land tax might contribute to promoting equality.[9] Second, from the perspective of the Haig-Simons comprehensive income model,[10] the New Zealand tax system has a significant gap in its tax base, inasmuch as capital gains are not generally taxed. A land tax might go some way to filling this gap. Furthermore, property is, in general, lightly taxed in New Zealand.[11] Third, due in part to the lack of a capital gains tax (CGT),[12] investment in New Zealand is heavily skewed towards residential property.[13] While certain measures have been taken to limit the tax advantages of investment in real property,[14] a land tax could steer investors to more productive areas of the economy. Finally, such a tax might encourage the optimal use of land and thereby facilitate urban planning.

In this article, we consider the possibilities of a national land tax. In part 2 we sketch the theoretical underpinnings of land taxation along with its legislative history in New Zealand and contemporary local arrangements. In part 3, we apply generally accepted tax criteria to land tax proposals. We also take into account other relevant considerations, including visibility and political plausibility. Our particular concern is to examine proposals for a national land tax as a substitute for a CGT.

2. LAND TAXATION: AN OVERVIEW

In this part, we sketch the theoretical arguments for a land value tax (LVT) and the history of property taxation in New Zealand. We also outline current, local rating arrangements. At the outset, the important distinction between property taxes and LVTs should be noted. Richard Dye and Richard England explain the distinction thus:[15]

> The traditional property tax applies the same rate to both improvement values and land values. A pure land tax exempts improvement values from taxation

[8] New Zealand's Gini coefficient increased from 0.27 in 1985 to 0.33 in 2008. (A Gini coefficient tending towards unity indicates greater inequality.) See *An Overview of Growing Income Inequalities in OECD Countries: Main Findings* OECD (2011) 24 <http://www.oecd.org/dataoecd/40/12/49170449.pdf>. We do not propose a causal connection between the abolition of the land tax and the increase in inequality.

[9] Alan Carter and Stephen Matthews, 'How Tax Can Reduce Inequality' (2012) 290/91 (Q1-Q2) *OECD Observer* 53, 53-54.

[10] See R M Haig, 'The Concept of Income', in R M Haig, T S Adams and T R Powell (eds), *The Federal Income Tax* (first published 1921, BiblioBazaar, 2009 ed) 7 and H C Simons, P*ersonal Income Taxation: The Definition of Income as a Problem of Fiscal Polic*y (University of Chicago Press, 1938) 50.

[11] Local Government Rates Inquiry Panel, *Funding Local Government: Executive Summary* (2007) ('Shand Report') 2.

[12] Other factors include: underdeveloped capital markets, particularly since many utilities are state-owned enterprises; Reserve Bank lending directives that favour mortgages over loans for business investment; and planning rules that restrict development in peri-urban areas.

[13] OECD, *OECD Economic Surveys: New Zealand* (OECD, 2011) 6-7.

[14] For example, prior to the start of the 2011-2012 income year, a 20 per cent loading that was added to the depreciation rates for most new assets did not apply to buildings. Since the start of the 2011-2012 income year, no deduction for depreciation can be claimed on most types of buildings, including investment properties. See *Income Tax Act 2007* (NZ) s EE 31(3).

[15] Richard F Dye and Richard W England, 'The Principles and Promises of Land Value Taxation' in Richard F Dye and Richard W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, 2009) 3, 4 n 1.

> altogether and taxes only land values. A graded, dual-rate, or split-rate property tax applies a lower rate to improvement values. The term land tax valuation is used to represent both its pure and partial forms.

Broadly, a property tax is a proxy for income tax and, rightly or wrongly, presumes that a certain level of property holdings indicate a certain ability to pay taxes on a regular basis. In contrast, an LVT is about the land itself – its scarcity, immovability and centrality to human activity.

2.1 Theory

Among others, William Petty,[16] François Quesnay, Adam Smith, David Ricardo and John Stuart Mill have supported versions of land taxation.[17] For Quesnay and the Physiocrats, taxing land value 'was justified because [of the] productiveness of land … since all taxes had to be paid out of rent, it would be sensible to replace all other taxes by a single tax on rent'.[18] In his analysis of suitable subjects for taxation, Smith argued:[19]

> Ground-rents are a still more proper subject of taxation than the rent of houses. A tax on ground-rents would not raise the rents of houses. It would fall altogether upon the owner of the ground-rent, who acts always as a monopolist, and exacts the greatest rent that can be got for the use of his ground.

Ricardo's theory 'was largely based on the premise that a tax on land rents would not have harmful effects on the economy as such a tax … [and] would not inhibit production'.[20] Mill 'suggested that if the rent of land increases as a result of society, the owners of the land should have no claim to this 'windfall' increase in land value'.[21]

Despite these august authorities, Henry George, whom Joseph Stiglitz describes as 'a great progressive of the late nineteenth century',[22] was the most prominent proponent of land value taxation. George argued that 'an increase in land values would be due to increased productivity which was closely related to increases in population and wealth. The rental income gave land its value and as such could be collected in taxes without decreasing incentives for efficient production.'[23] Progress and Poverty,[24]

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[16] On Petty and land taxes, see Eric Roll, *A History of Economic Thought* (4th ed, Faber and Faber, 1973) 102-103. Karl Marx described Petty as 'the father of political economy'. Ibid, 100.
[17] William J McCluskey and Riël C D Franzsen, *Land Value Taxation: An Applied Analysis* (Ashgate, 2005) 3.
[18] Ibid.
[19] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (first published 1776, Encyclopaedia Britannica, Chicago, 1952 ed) 370.
[20] McCluskey and Franzsen, above n 17, 3.
[21] Ibid.
[22] Joseph E Stiglitz, 'Principles and Guidelines for Deficit Reduction' (Working Paper No 6, The Roosevelt Institute, 2010) 5.
[23] McCluskey and Franzsen, above n 17, 3.
[24] Henry George, *Progress and Poverty* (first published 1879, Hogarth Press, 1953 ed).

which set out George's proposal for a single land tax on the 'unearned increment',[25] attracted much attention in New Zealand.[26] As in California and Victoria, a practical scarcity of land in colonial New Zealand arose as a consequence of speculation.[27] Furthermore, contrary to 'the vision several leading Liberals had for New Zealand as a thriving rural economy populated by yeoman farmers',[28] the possibility of a landed 'aristocracy' forming as a consequence of land aggregation was feared, particularly by settlers whose families had experienced the Highland Clearances.

William McCluskey and Riël Franzsen argue that George's ideas influenced 'the politicians of the day in New Zealand, Australia, South Africa, Jamaica and Kenya to introduce such a tax',[29] but Gareth Morgan and Susan Guthrie observe that, despite being well known, George's views 'had little impact', with Mill appearing to have been more influential.[30] Nevertheless, Paul Goldsmith concludes that the first Liberal government, led by John Ballance, while not persuaded to implement George's radicalism, did wish to 'recover for the state at least a portion of the 'unearned increment' through a land tax'.[31] This wish was reflected in the progressive Land and Income Tax Assessment Act 1891 (NZ), which 'had the specific purpose of breaking up the large estates (so property ownership could be more evenly spread throughout the community)'.[32]

2.2 Legislative History

Notwithstanding an experimental property tax levied in the colonial period,[33] New Zealand's first direct tax was a land tax enacted in 1878.[34] This was succeeded in 1879

[25] Unearned increment may be defined as 'the value arising from all the government and private activities making the land reachable, livable, and richly salable, and from artificial scarcity produced by withholding land from its best use waiting for society to increase the value'. See Richard W Landholm, 'Twenty-One Land Value Taxation Questions and Answers' (1972) 31(2) *American Journal of Economics and Sociology* 153, 156.

[26] Robert D Keall, 'New Zealand: Land and Property Taxation' (2000) 59(5) *American Journal of Economics and Sociology* 417, 422.

[27] See, James Belich, *Replenishing the Earth: The Settler Revolution and the Rise of the Anglo-World, 1783-1939* (Oxford University Press, 2009) 186-187.

[28] Paul Goldsmith, *We Won, You Lost, Eat That!: A Political History of Tax in New Zealand since 1840* (David Ling, 2008) 83. See, also, Michael King, *The Penguin History of New Zealand* (Penguin Books, 2003) 260-261 on Liberal policies aimed at breaking up the large estates that had formed when 'sheep was king'.

[29] McCluskey and Franzsen, above n 17, 4-5.

[30] Gareth Morgan and Susan Guthrie, *Tax and Welfare: The Big Kahuna* (Public Interest Publishing, 2011), 91. However, while George may not have influenced national taxation, his ideas may have informed the land value elements of the local *Rating Acts Amendment Act 1893* 57 Vict 43.

[31] Goldsmith, above n 28, 84. However, Goldsmith records the remarkable arrangement under the *Land Act 1892* (NZ) whereby farmers could lease land from the government on 999 year leases at a rental of four per cent of capital value which would not be revalued during the term of the lease. He observes: 'If there was any such thing as the 'unearned increment', under this arrangement the government would get none of its whatsoever.' Ibid, 85.

[32] Morgan and Guthrie, above n 30, 71.

[33] The *Property Rate Ordinance 1844* 8 Vict 2 taxed both real and personal property, and income. New Zealand was a Crown colony from 1840 until 1856 when responsible government was conferred on the settlers.

[34] *Land Tax Act 1878* (NZ).

by a property tax, which included personal property in its base,[35] although a substantial exemption of £500 applied. The rate of tax in the first year was 1d/£1 (0.4 per cent). The property tax was repealed by the Land and Income Tax Assessment Act 1891 (NZ). This Act provided for a tax 'on land and all mortgages held on land and also for a tax on income from business and emoluments'.[36] Initially the tax was levied on a split rate basis:[37] the ordinary land tax was levied at a rate of 1d/£1 (0.4 per cent) on the capital value of land owned less the value of improvements up to £3,000 and less the amount of any mortgages owing. The graduated land tax was levied at rates ranging from ⅛d/£1 (0.05 per cent) on the unimproved value of land over £5,000 to 1¾d/£1 (0.7 per cent) on the unimproved value in excess of £210,000.[38] From 1894, the land tax was levied on unimproved land value only,[39] and so can be considered an LVT proper.

The land tax was originally a major source of national revenue; indeed, its yield constituted 75.7 per cent of total land and income tax revenue in 1895.[40] The tax 'also served a social purpose in acting as an inducement to the breaking up of unduly large land holdings'.[41] However, the land tax also led to avoidance and evasion, and costly challenges to valuations.[42] Opponents argued that the land tax hindered development and drove capitalists offshore.[43] Furthermore, illustrating the problems of practical ability to pay that arise from property taxation and LVTs, payment in years when the owner made a loss caused resentment.[44]

In 1967, recommending the abolition of land tax,[45] the Ross committee observed that 'the revenue from land tax has dwindled to a very minor proportion of total Government revenue' – a mere 0.5 per cent of total land and income revenue by 1965.[46] The committee also noted that the 'tax is no longer necessary or effective as a means of breaking up large land holdings'.[47] However, the tax was not repealed as recommended and its fiscal significance decreased further, so that it contributed just one per cent of direct tax revenues in 1982.[48] Reporting in that year, the McCaw task force noted that the land tax was 'simple and cheap to collect' but had 'no perceptible redistributive effect' and was 'not an adequate indicator of the taxable capacity provided by wealth'.[49] Unlike the Ross committee, the McCaw task force refrained from making any recommendations about the land tax. Nevertheless, the practice of

[35] *Property Tax Act 1879* (NZ).
[36] *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, 1967) ('Ross Report') 410.
[37] Ibid, 410.
[38] Ibid.
[39] Ibid.
[40] Ibid, 413.
[41] Ibid.
[42] Morgan and Guthrie, above n 30, 92.
[43] Ibid, 77.
[44] Ibid.
[45] Ross Report, above n 36, 415.
[46] Ibid, 413.
[47] Ibid.
[48] *Report of the Task Force on Tax Reform* (Government Printer, 1982) ('McCaw Report') 228. In 1960, land tax contributed six per cent of direct tax revenues. In the same period, the land tax as a percentage of gross domestic product (GDP) fell from 0.9 per cent to 0.2 per cent. Ibid.
[49] Ibid, 230.

taxing income and land under the same legislation ended when the separate Income Tax Act 1976 (NZ) and Land Tax Act 1976 (NZ) were enacted. Finally, the Land Tax Abolition Act 1990 (NZ) repealed the land tax with effect from 31 March 1992.

Why did the land tax, which was originally such a major source of national government revenue and, indeed, an important instrument of social engineering, become so insignificant? To a great extent, successive governments allowed the tax to fail. Philosophically, a policy shift from taxing Georgian 'unearned increment' to taxing comprehensive income in terms of the Haig-Simons principle can be discerned.[50] Thus, from the 1940s, around the world, income tax brought many more people into the tax net and, as a consequence, grew exponentially in importance for government revenue.[51] With the ascendency of income tax, no incentive lay in formulating a better land tax.[52] Another narrative is that of the unwillingness of New Zealand governments since the 1980s to tax capital.[53] In practice, the land tax was undermined by exemptions: in 1982, only five per cent of total land value was taxed, 'agricultural land being explicitly exempted and residential land effectively exempted by the exemption of $175,000 for all landowners'.[54] Furthermore, it was thought that effective use of a national LVT was limited because local property rates constitute the principal source of local authority revenue.[55]

2.3 Contemporary Land Taxation

The Local Government Act 2002 (NZ), which introduced significant changes to local government in New Zealand,[56] empowers local authorities to pursue their communities' social, economic, environmental and cultural well-beings.[57] Through processes of community consultation and deliberation, local authorities must formulate community outcomes, derived from these four well-beings. A long-term plan, which a local authority must have at all times,[58] is an evolving and rolling blueprint for achieving those community-specific outcomes. The Local Government (Rating) Act 2002 (NZ) invests local authorities with powers to charge rates 'in order to promote the purposes of the [Local Government] Act'.[59] The four types of rates that

[50] This is not to suggest that the New Zealand government ever explicitly conceived the land tax in Georgian terms, rather than broad ability to pay.

[51] See, for example, Tom Clark and Andrew Dilnot, 'Long-Term Trends in British Taxation and Spending' Briefing Note No 25 (The Institute for Fiscal Studies, 2002).

[52] Morgan and Guthrie, above n 30, 77.

[53] Cf the abolition of the capital transfer tax system. *Estate Duty Abolition Act 1993* (NZ) s 3 abolished estate duty in respect of deaths occurring on or after 17 December 1992, but gift duty, which was ancillary to estate duty, was somewhat oddly retained. In the absence of estate duty and the presence of generous concessions, gift duty was subsequently considered ineffective and eventually repealed by the *Taxation (Tax Administration and Remedial Matters) Act 2010* (NZ).

[54] McCaw Report, above n 48, 230.

[55] Ibid. G Bush, 'Local Government in R Miller (ed), *New Zealand Government and Politics* (Oxford University Press, 2003) 161, 164 reports that in 2001 an average of 57 per cent of local authority revenue was contributed by rates (excluding user charges).

[56] See, generally, Vivienne Wilson and Jonathan Salter, *A Guide to the Local Government Act 2002* (Brookers, 2003).

[57] *Local Government Act 2002* (NZ) s 10.

[58] *Local Government Act* s 93(1).

[59] *Local Government (Rating) Act 2002* (NZ) s 3. The *Rating Valuations Act 1998* (NZ) provides for methods of land valuation and the *Land Valuations Proceedings Act 1948* (NZ) provides for a system of appeals against those valuations. The *Rates Rebate Act 1973* (NZ), which establishes a scheme of rates

may be charged are:[60] a general rate, chargeable against all rateable land;[61] a fixed amount, universal annual general charge (UAGC), payable in respect of each rateable unit;[62] a targeted rate for particular activities identified in a local authority's funding impact statement, such as waste removal;[63] and a targeted rate for water supplied.[64] The aggregate of targeted rates (excluding the water rate) and UAGCs may not exceed 30 per cent of a local authority's total rates revenue.[65] Differentiated rates may be charged for different categories of land.[66]

In setting the general rate, local authorities may use land value (unimproved value), capital value (improved value) or annual value (imputed rental from improved land).[67] While land value is traditionally thought to be the 'natural' base for rural authorities, and capital for urban areas,[68] some urban authorities use a land base and some rural authorities a capital base.[69] At the risk of imputing a degree of theory that may not in practice inform local authorities' decisions in this regard,[70] capital value rating may be seen as a proxy income tax and a land base as an LVT that incentivises optimal development.[71]

McCluskey and Franzsen observe that '[h]istorically, as the primary focus of local government was for the provision of services to property (for example water supply, sewerage, stormwater drainage), ratepayers were considered to be the direct beneficiaries of these services'.[72] The general competence powers extended to local authorities under the Local Government Act may, to some extent, have broken this nexus. However, reforms proposed by the current National-led government that would restrict local authority activities might revive the obvious connection between

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rebates disbursed by central government, is not part of the locally constructed rating system but affects final rating outcomes.

[60] *Local Government Act* part 8, subpart 5 provides for a charge in relation to new developments.

[61] *Local Government (Rating) Act* s 13.

[62] *Local Government (Rating) Act* s 15.

[63] *Local Government (Rating) Act* s 16.

[64] *Local Government (Rating) Act* s 19. The distinction between rates (revenue tax), charges (fees linked to expenditure of a council) and user charges (specific cost recoveries) has been judicially recognised. See *Neil Construction v North Shore City Council* (unreported, High Court, Auckland Registry, Auckland, CIV 2005-404-4690, 21 March 2007 [44], Potter J).

[65] *Local Government (Rating) Act* s 21.

[66] *Local Government (Rating) Act* s 13(2)(b).

[67] *Local Government (Rating) Act* s 13(3). Before 1896, when land value became a base option, use of annual value was normal but is now of historical interest only. See also McCluskey and Franzsen, above n 17, 10-13 for a discussion of land tax base options.

[68] See Rolland O'Regan, *Rating in New Zealand* (2nd ed, Baranduin Publishers, 1985) 38; K A Palmer, *Local Government Law in New Zealand* (2nd ed, Law Book Co, 1999) 338.

[69] See William McCluskey with Arthur Grimes and Jason Timmins, *Property Taxation in New Zealand* Local Government New Zealand 4 <http://www.lgnz.co.nz/library/files/store_005/property_taxes.pdf>.

[70] William McCluskey et al, 'Rating Systems in New Zealand: An Empirical Investigation into Local Choice' (2006) 14(3) *Journal of Real Estate Literature* 381, 394 observe that 'wealthier local authorities tend to adopt a capital value rating system in preference to a land value rating system … there is a correlation between the level of revenue raised and the level of local expenditure … local authorities in wealthier areas can afford to spend more lavishly on services than can authorities is poorer areas'.

[71] See Palmer, above n 68, 364. C D Foster, R Jackman and M Perlman, *Local Government Finance in Unitary State* (George Allen and Unwin, 1980) 170; Jonathan Barrett, 'Equity in Local Government Rating' (2007) 13(4) *New Zealand Journal of Taxation Law and Policy* 621, 625-633.

[72] McCluskey and Franzsen, above n 17, 141.

ratepaying and enjoyment of basic services.[73] Does the close connection between local property taxes and locally provided services preclude a national LVT?

Since local rating and a national land tax ran parallel for a century in New Zealand, the idea that property taxes are the unique preserve of local government is not historically plausible. Australia continues to provide an example of different tier political sub-divisions sharing the same basic tax base.[74] Indeed, given the shift towards capital value taxation in rating,[75] it might be argued that an LVT would have a different base from rates. As in many other countries,[76] property is, in general, lightly taxed in New Zealand. Although the rates yield of an amount approximately equal to two per cent of GDP (in 2008) is in line with the OECD average, yield as a percentage of aggregate housing value fell from 2.2 per cent in 1980 to 0.65 per cent in 2008.[77] Furthermore, between 1991 and 2002, aggregate land value grew at 4.8 per cent a year, while per capita growth in GDP was approximately two per cent over the same period.[78] Since rates are 'somewhat regressive in their impact',[79] scope exists not only for making existing 'property taxes both fairer and less distortive',[80] but also to accommodate a low rate national LVT.

3. IS A NATIONAL LVT DESIRABLE?

Andrew Coleman and Arthur Grimes present a plausible national LVT model for New Zealand. A one per cent LVT on all non-government land would raise revenue equivalent to 20 per cent of current income tax yield.[81] Adopting, in part, the Coleman-Grimes model, a majority of the Tax Working Group recommended an LVT.[82] Smith famously proposed equity, certainty, convenience and efficiency as the four 'maxims with regard to taxes in general'.[83] We have already noted that, having

[73] Local Government Act 2002 Amendment Bill 2012 (27-1) proposes a new purpose for local government of meeting 'the current and future needs of communities for good quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost-effective for households and businesses'. The Bill also provides for the establishment of financial prudence requirements, sets benchmarks for local authorities' performance in respect of income and expenditure, and establishes 'prudent debt levels'. Ibid, explanatory note.

[74] Coleman and McKerchar, above n 1, 293.

[75] Of the seven former councils that now comprise the so-called Auckland 'super city', only one used capital value before the merger. However, the merged council, which governs one third of the country's population, uses capital value. See Property Valuation Auckland Council (2011) <http://www.aucklandcouncil.govt.nz/EN/ratesbuildingproperty/ratesvaluations/propertyvaluation/Pages/generalrevaluation2011.aspx?>.

[76] See Carter and Matthews, above n 9, 54.

[77] Calista Cheung, 'Policies to Rebalance Housing Markets in New Zealand' (Working Paper No 878, OECD Economics Department, 2011) 20.

[78] McCluskey et al, above n 70, 387.

[79] Shand Report, above n 11, 2.

[80] Carter and Matthews, above n 9, 54.

[81] Andrew Coleman and Arthur Grimes, 'Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes' (2010) 44(2) *New Zealand Economic Papers* 179, 179-199.

[82] Tax Working Group, above n 5, 50. The Tax Working Group contemplated a 0.5 per cent tax that would raise up to $2.3 billion or 10 per cent of income tax revenue. Ibid, 45.

[83] Smith, above n 19, 361-362. Similarly, for the Commonwealth, *Australia's Future Tax System: Report to the Treasurer* (2010) ('Henry Report') Executive summary, vii economic efficiency, equity

applied these criteria, Smith favoured a ground rent tax.[84] However, in this part we apply anew Smith's maxims and other relevant considerations to LVTs in a contemporary context. The Coleman-Grimes model indicates that a national LVT is economically plausible but is it otherwise desirable for New Zealand?

3.1 Equity

LVTs are premised on a radical conception of equity. 'George argued that taxes on land promote fairness because the value of the land is determined by community rather than individual efforts.'[85] Since the economic rent arising from land value is considered an unearned surplus brought into existence by the activities of the community in general, rather than anything the owner has done,[86] it is eminently taxable. Furthermore, the burden of an LVT falls entirely on landowners.[87] Equity in this fundamental sense is plausible, but people have been inured to the idea that ability to pay during the assessment period, which lies in horizontal equity (fairness in the tax base) and vertical equity (fairness in tax rates), is the badge of equity. Vertical equity issues are less relevant for LVTs than for, say, income tax because LVT rates tend to be low,[88] although not as low as property tax rates, and are likely to draw less attention if they are flat.[89] However, horizontal equity is a more contentious issue. As Elizabeth Plummer observes, '[i]f land value as a percentage of net wealth increases as household income increases, then a land value tax will be progressive … [but] land value as a percentage of net wealth decreases as wealth increases, which suggest that a land value tax might be somewhat regressive'.[90] Older people, often on fixed incomes, would be significantly affected by a shift to property taxation since, even though inequities between taxpayers seem to be far greater where capital value, rather than land value is used,[91] superannuitants tend to own disproportionately expensive properties relative to their incomes. However, '[d]ifferences in land ownership

(horizontal, vertical and intergenerational), and simplicity were key, and the Tax Working Group, above n 5, 9 identified the six principles of a good tax system as: the overall coherence of the system, efficiency and growth, equity and fairness, revenue integrity, fiscal cost, and compliance and administration costs.

[84] Smith, above n 19, 379.

[85] Dye and England, above n 15, 4.

[86] For a discussion, see Owen Connellan, with contributing authors Nathaniel Lichfield, Frances Plimmer and Tony Vickers, *Land Value Taxation in Britain: Experience and Opportunities* (Lincoln Institute of Land Policy, 2004) 11.

[87] Wallace E Oates and Robert M Schwab, 'The Simple Analytics of Land Value Taxation' in Richard F Dye and Richard W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, 2009) 51, 71.

[88] A historical curiosum may be noted. In 1757, the English land tax reached a rate of 4s/£1 (20 per cent). See Asa Briggs, *A Social History of England* (Weidenfeld and Nicolson, 1983) 167.

[89] See Morgan and Guthrie, above n 30, 93 for argument why LVT rates should not be progressive.

[90] Elizabeth Plummer, 'Fairness and Distributional Issues' in Richard F Dye and Richard W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, 2009) 73, 98. For an argument that land value base is more progressive than a capital base, see Suzi Kerr, Andrew Aitken and Arthur Grimes, 'Land Taxes and Revenue Needs as Communities Grow and Decline: Evidence from New Zealand' (Working Paper 04-01, Motu Economic and Public Research, 2004) 28.

[91] See G Stacy Sirmans, Dean H Gatzlaff and David A Macpherson, 'Horizontal and Vertical Inequity in Real Property Transactions' (2008) 16(2) *Journal of Real Estate Literature* 167, 167-180.

patterns make it difficult to generalize across countries, states, or even cities when considering the distributional effects of a land value tax'.[92]

In short, while an LVT promises to deliver equity in a fundamental way, it is likely to be considered inequitable by those negatively affected: we revisit this problem under the heading of political plausibility below.

3.2 Efficiency

An LVT is economically neutral,[93] and is, therefore, 'efficient in that it does not distort investment choices',[94] such as the timing of land development,[95] and, therefore, does not generate an excess burden (deadweight loss).[96] Since land is inelastic in supply, 'no adverse supply side effects' arise from the introduction of an LVT as many other new taxes do.[97] In terms of economic efficiency, LVTs are often favourably compared with property taxes:[98] as Richard Lindholm observes, an LVT 'takes the burden of the property tax off value created by individual effort and places it on the value created by society'.[99] However, the exclusion of individual effort from the tax net also critically distinguishes LVTs from income tax.

The very nature of the subject of taxation presents economic advantages for LVTs. The large and fixed supply of land enables high revenue from a low rate.[100] In the aftermath of the global financial crisis, LVTs may also contribute to stabilising the world economy, particularly by preventing capital flight.[101] As Terry Dwyer argues, '[i]n a world that is mobile and labour supply is shrinking in line with demographic decline, an immobile tax base is the only tax base which makes economic sense'.[102]

3.3 Certainty

'One of the biggest challenges for land value taxation is obtaining accurate defensible land values.'[103] Indeed, because fixing land value is far more challenging than assessing capital value, Edwin Mills concludes that likelihood of valuation errors

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[92] Riël C D Franszen, 'International Experience' in Richard F Dye and Richard W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, 2009) 27, 47.

[93] T Nicolaus Tideman, 'A Tax on Land Value *Is* Neutral' (1982) 35(1) *National Tax Journal* 109, 109-111

[94] Dye and England, above n 15, 4.

[95] Oates and Schwab, above n 87, 71.

[96] Stiglitz, above n 22, 5.

[97] For a discussion, see Connellan et al, above n 86, 11.

[98] Nobel laureate William Vickrey concludes: 'The property tax is, economically speaking, a combination of one of the worst taxes – the part that is assessed on real estate improvements … and one of the best taxes – the tax on land or site value.' Quoted by Sally Kwak and James Mak, 'Political Economy of Property Tax Reform: Hawaii's Experiment with Split-Rate Property Taxation' (2011) 70(1) *American Journal of Economics and Sociology* 4, 4-5.

[99] Richard W Lindholm, 'Twenty-One Land Value Taxation Questions and Answers' (1972) 31(2) *American Journal of Economics and Sociology* 153, 153.

[100] Tax Working Group, above n 5, 50.

[101] Michael Kumhof and Romain Rancière, 'Leveraging Inequality' (2010) 47(4) *Finance & Development* 28, 31.

[102] Terry Dwyer, 'The Taxable Capacity of Australian Land and Resources' (2008) 18 *Australian Tax Forum* 21, 41.

[103] Plummer, above n 90, 96.

vitiates the advantages of an LVT.[104] Jeffrey Chapman and his co-authors argue that such claims are overstated,[105] and, despite, say, a paucity of vacant lots in urban areas to act as comparators, skilled assessors can develop plausible valuation techniques.[106] Thus Alan Carter and Stephen Matthews observe that 'out-of-date values for tax purposes often distort the efficiency of property markets (by discouraging individuals from moving home, thus reducing labour mobility)'.[107] Valuation of the tax base for an LVT may have a disproportionate effect both on equity and economic efficiency in a way that does not apply to taxes whose bases comprises different components.[108] Without gainsaying the importance of accurate valuation to an LVT, we submit that Alan Dornfest's prescriptions for valuation practice would contribute significantly reducing both equity and efficiency risks.[109]

3.4 Convenience

In New Zealand, a national LVT would be convenient for both government and taxpayers because of the existing local government rating system:[110] taxpayers would not, for example, need to keep records of property values in the way of a CGT. However, taxation of unrealised capital gains is problematic because tax on wealth, rather than current cash flows, impacts on practical ability to pay, especially when markets are volatile.[111] In rejecting a 'factor tax', which would apply only to farmland, the Ross committee considered practical ability to pay to be a critical concern, particularly the effects on farmers' income of flooding or movements in international commodity prices.[112] It might be argued that landowners with volatile incomes should engage in contingency planning, but, as the committee recognised, the impact of the tax could drive some farmers off their land.[113]

Notwithstanding individual 'inconvenience', economically inefficient landowners leaving their land might be seen as promoting aggregate utility. However, a particular problem such a crudely utilitarian argument faces in New Zealand is the impact on under-utilised Māori land. As Levente Tímár observes, 'Māori freehold land is

[104] Edwin S Mills, 'The Consequences of a Land Tax' in Dick Netzer (ed), *Land Value Taxation: Can It and Will It Work Today?* (Lincoln Institute of Land Policy, 1998) 31, 31-48.
[105] Jeffrey C Chapman, Robert J Johnston and Timothy J Tyrrell, 'Implications of a Land Tax with Error in Assessed Values' (2009) 85(4) *Land Economics* 576, 584.
[106] Roy Bahl and Sally Wallace, 'A New Paradigm for Property Taxation in Developing Countries' in Roy Bahl, Jorge Martinez-Vazquez (eds), Challenging the Conventional Wisdom on the Property Tax (Lincoln Institute of Land Policy, 2010) 165, 175.
[107] Carter and Matthews, above n 9, 54.
[108] If one item is wrongly valued for goods and services tax purposes, the consequences are likely to be trivial for the taxpayer, but if the sole taxed item under an LVT is wrongly valued, the consequences for the taxpayer are likely to be significant.
[109] These include: annual assessment to ensure current market value; frequent reappraisals contingent on quality thresholds; quality assurance of valuators and high quality and accurate land records. See Alan S Dornfest, 'In Search of an Optimal Revaluation Policy: Benefits and Pitfalls' in Roy Bahl, Jorge Martinez-Vazquez (eds), Challenging the Conventional Wisdom on the Property Tax (Lincoln Institute of Land Policy, 2010) 75, 102.
[110] Tax Working Group, above n 5, 50.
[111] Steven C Bourassa, 'The Political Economy of Land Value Taxation' in Richard F Dye and Richard W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, 2009) 195, 195.
[112] Ross Report, above n 36, 291.
[113] Ibid.

underdeveloped relative to general land, even after taking into account differences in land quality and location. These findings are relevant for policy-makers because they could have important equity implications.'[114] The Georgian LVT came to prominence at a time when indigenous peoples were being displaced from their lands by European settlers; the idea that a contemporary LVT might have the effect of driving tangata whenua (original people of the land) from their current land holdings is politically unimaginable.

3.5 Other Considerations

3.5.1 Steering Investment

Personal investment in New Zealand is heavily skewed towards residential property. 'New Zealanders have twice as much capital sunk into houses (and the land underneath) as they hold in financial assets such as bank deposits and managed funds. They've been encouraged to do this by the tax system.'[115] As Morgan and Guthrie observe, these tax preferences have 'grossly distorted how wealth has been invested and has led to a considerable waste of capital'.[116] The OECD argues that the omission of 'imputed rents and capital gains from the NZ tax base contributes to diverting household portfolios towards housing … measures [taken so far] should be accompanied by higher property or land taxes that could be designed to achieve the same objectives as a tax on imputed rent'.[117]

Clinton Alley and Michael Davis propose a land transfer levy to tax wealth accretions through property: the main purpose of the tax would be to correct the tax induced preference for investment in residential property in New Zealand.[118] The authors observe: 'It does require political intent to make the change for the betterment of future generations in this macro-economic marketplace. The abiding question is, who has the will to plant the seed for New Zealand's future by introducing a low-rate land transfer levy reforms?'[119] Political preference lies at the root of property taxes in New Zealand. Singling out real property owners, particularly farmers,[120] for special tax treatment would, indeed, appear to constitute a brave political move; however, both the Labour and Green parties, which might plausibly form a future government,

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[114] Levente Tímár, *Rural Land Use and Land Tenure in New Zealand* (Working Paper 11-13, Motu Economic and Public Policy Research, 2011) 36-37.

[115] Morgan and Guthrie, above n 30, 137 (n omitted). However, it would be wrong to suggest that favourable taxation is the sole or principal reason for New Zealanders' 'obsession' with property investment. Immature capital markets, migration patterns and 'easy credit conditions' have made rental property an attractive investment option. See Cheung, above n 77, 6.

[116] See Morgan and Guthrie, above n 30, 122.

[117] See OECD, *OECD Economic Surveys: New Zealand* (OECD, 2011) 6-7. This is not a proposal for an LVT proper, rather for a limited form of wealth taxation. It should also be noted that New Zealand does not extend any form of mortgage relief to home owners.

[118] Clinton R Alley and Michael J Davies, 'A Land Transfer Levy with Equity as the Key: A Preliminary Examination into an Alternative Regime to Generate Broad-Based Tax Revenue' (2011) 17 *New Zealand Journal of Taxation Law and Policy* 309, 309.

[119] Ibid, 338.

[120] In its recommendations for broadening the base of Australian land taxes, the Henry Report, above n 88, Executive summary, xxi envisaged 'most land in lower-value use (including most agricultural land) would not face a land tax liability'. Likewise, the Tax Working Group, above n 5, 51 contemplated farms and forestry land being exempt from an LVT.

support a CGT.[121] The Tax Working Group proposed a land tax principally because a CGT was thought to face insurmountable political hurdles.[122] But, if the political will already exists to pursue a CGT; that is surely the best option from a perspective of filling the gap in the Haig-Simons comprehensive income model.[123] As the New Zealand Productivity Commission concluded on the possibility of a specific tax on real property gains in lieu of a CGT, '[a]ddressing particular anomalies in isolation from a broad review of the tax system would further complicate the system and could have unintended effects on housing markets and housing affordability.'[124]

3.5.2 Urban planning

Spencer Banzhaf and Nathan Lavery argue that an LVT increases the number of housing units erected on an area of land, and the consequent higher density of housing 'is potentially a powerful anti-sprawl tool'.[125] However, due to green or town belt policies generally adopted by New Zealand cities, urban sprawl does not tend to be an issue.[126] Indeed, Don Brash argues that current urban limits should be extended in order to decrease the price of residential land.[127] The significance of an LVT in this context as an urban planning tool is not obvious, although an LVT that reduces the price of land might lead to better housing affordability.

Since more intensive use of land may lead to unduly dense development or the destruction of heritage buildings,[128] to be effective as an urban planning tool, an LVT would need to be integrated with other planning mechanisms. However, since urban and environmental planning in New Zealand is highly localised,[129] it is difficult to see how a national LVT could be integrated in the way that local rates may be.

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[121] See Vernon Small and Tracey Watkins, 'Shearer No Big Spender as Labour's Future Direction Begins to Unfold' *The Dominion Post* (Wellington), 16 March 2012, 2 and Isaac Davison, 'Greens Sound Warning on Govt's 'Reckless' Path' *The New Zealand Herald* (Auckland), 5 June 2012, 4.

[122] For an analysis of the implausible arguments against CGT that have traditionally proved persuasive across the political spectrum, see Chye-Ching Huang and Craig Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special?' (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 269, 269-306.

[123] The type of tax contemplated here appears to be a property tax, rather than an LVT. Thus, the tax would constitute a CGT substitute in relation to a particular class of property. See Andrew Coleman, 'The Long-Term Effects of Capital Gains Taxes in New Zealand' (Working Paper 09-13, Motu Economic and Public Research) 2.

[124] New Zealand Productivity Commission, *Housing Affordability Inquiry* (New Zealand Productivity Commission, 2012) 101.

[125] H Spencer Banzhaf and Nathan Lavery, 'Can the Land Tax Help Curb Urban Sprawl? Evidence from Growth Patterns in Pennsylvania' (2010) 67 *Journal of Urban Economics* 169, 169-179. See also Wallace E Oates and Robert M Schwab, 'The Impact of Urban Land Taxation: The Pittsburgh Experience' (1997) 50(1) *National Tax Journal* 1, 1-21; Landholm, above n 25, 156-157.

[126] In Auckland, where urban sprawl has the greatest potential to take place, there is little demand for land at the urban limits compared to inner city sections. See Greg Ninness, 'House Price Solution in Funding, Not in More Land' *Sunday Star-Times* (New Zealand), 22 July 2012, 4.

[127] 'NZ Has Land Supply Problem, Not House Price Problem – Brash', *The National Business Review* (online), 16 July 2012 <http://www.nbr.co.nz/article/house-pricing-land-cost-ridiculous-says-brash-ck-123568>.

[128] Bourassa, above n 111, 196. It is uncontroversial that heritage buildings should be preserved, but people seem to want denser urban development, which may have general environmental benefits.

[129] See generally *Local Government Act* and *Resource Management Act 1991* (NZ).

3.5.3 Visibility

Unlike, say, income tax deducted on a pay as you earn (PAYE) basis, property taxes, are egregiously visible to taxpayers.[130] The 'ritual' of paying local rates usefully focuses the minds of taxpayers on the services they receive from their local authorities,[131] but visibility can present psychological barriers, particularly, to property taxes.[132] Because LVTs tend to require higher nominal rates than property taxes, they are 'politically highly visible and possibly less acceptable to property owners'.[133] Conversely, as Roy Bahl and Sally Wallace observe, taxpayer resistance may also arise when 'visible, high-value structures' are not taxed. Ultimately, consistent with the Tiebout hypothesis,[134] we may assume that the nominal rate of an LVT would not be the critical concern for taxpayers, who ' may be prepared to endure high nominal rates if they are satisfied with effective tax rates and if they receive acceptable levels of government services in return'.[135]

3.5.4 Lack of Understanding

Robert Keall argues:[136]

> … resource rental is not just another tax … it is the alternative to taxes on endeavor. Widespread understanding of this crucial point provides the political dynamic essential for the ultimate adoption of a thoroughgoing resource rental system of public revenue.

Unfortunately, for its proponents, LVTs are not generally understood.[137] Indeed, even at the height of enthusiasm for the Georgian single tax, his 'sophisticated arguments … were understood only by a few in New Zealand and accepted by fewer'.[138]

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[130] David Brunori, *Local Tax Policy: A Federalist Perspective* (The Urban Institute, 2007) 7.

[131] Cf Goldsmith, above n 28, 222 on the historical ritual of writing out an annual income tax cheque. The broad demise of the cheque as a form of payment has probably reduced tax visibility, particularly for local rates.

[132] For example, Richard Bird argues that California's property tax-limiting Proposition 13 was attributable to increased visibility, rather than an increase in overall burden. See Richard M Bird, *Financing Canadian Government: A Quantitative Overview* (Canadian Tax Foundation, 1979) 41. See, also Amotz Morag, *On Taxes and Inflation* (Random House, 1965) 21 on the political desirability of invisible taxes. But, compare with the *Report of the Royal Commission on Taxation* ('Carter Commission') (Queen's Printer, 1966) vol 5, 36 on the democratic desirability of visible taxes.

[133] Franszen, above n 92, 47.

[134] C M Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy* 416, 424 proposed that, under conditions of full 'consumer-voter' mobility, people will select areas to live, based on their preferences for local government revenue-expenditure patterns.

[135] Franszen, above n 92, 47.

[136] Keall, above n 26, 437.

[137] Bourassa, above n 111, 196.

[138] Goldsmith, above n 28, 84.

3.5.5 Political Plausibility

In rating systems, a change from a capital to a land base creates winners and losers;[139] who loses or wins may impact on political discourse: a shift to a national LVT would amplify those currently localised concerns. Thus Carter and Matthews caution 'while the better off tend to own the most expensive residential property, there are many middle class owners too, so reform has to be approached cautiously, especially given the bruising many home-owners took from the housing bubble'. According to Sally Kwak and James Wak, Hawaii was able to introduce an LVT because, despite the traditional political power of landowners, they were small in number, whereas 'there were many more people who would gain'.[140] In contrast, assessing a Japanese LVT aimed at curbing soaring property values, Hiromitsu Ishi concludes 'the new land tax was emasculated by many modifications that were made for political reasons'.[141] Comparable compromises could be expected in New Zealand.[142] Approximately one third of New Zealanders live in Auckland and 'would be hammered by a proposed land tax, facing an annual bill running into thousands of dollars'.[143] Such concerns might be allayed if a radical change in the tax system, from comprehensive income to a land value base, were phased-in over a long period of time: for example, payment of LVT by the elderly, who often have high value land holdings but low incomes, could be deferred until they sell or bequeath their property.[144]

4. CONCLUSION

In this article, we have outlined the principal arguments for and against land value taxation. LVTs promise a radical form of equity that purports to tax the community-generated surplus that individual land owners enjoy. Economists have traditionally considered such a tax efficient, and, in the light of the global financial crisis, renewed interest has been shown in its potential for promoting economic stability. Conversely, LVTs are poorly understood; they are, for example, commonly seen as a form of property tax, which their proponents vigorously oppose. Should, then, New Zealand introduce a national LVT? The answer to that question depends on the outcomes sought. If the goal is to shore up a gap in the comprehensive income tax base, the answer must be negative: from a horizontal equity perspective, a CGT is a better and more obvious option.[145] However, if the goal is a radical shift from taxing endeavour to taxing the unearned increment inherent in immovable property, any answer must be

[139] See Auckland Council, above n 75 for an analysis of changes resulting from the shift from land (and annual value) to capital valuation.
[140] Kwak and Mak, above n 98, 10.
[141] Hiromitsu Ishi, 'Land Tax Reform in Japan' (1991) 32(1) *Hitotsubashi Journal of Economics* 1, 19.
[142] Cf how the Coleman-Grimes LVT model was watered down by the Tax Working Group. See above nn 86 and 87.
[143] Anne Gibson, 'Land Tax – What It Could Mean for You' *The New Zealand Herald* (Auckland), 30 January 2010, A1.
[144] See Lindholm, above n 99, 154-155 on different phasing-in options.
[145] The Tax Working Group's analysis of a land tax appears somewhat cursory. (See Tax Working Group, above n 5, 50-51). Perhaps its members realised that their recommendation lacked political plausibility and it was, indeed, duly ignored by government.

more tentative.[146] On the one hand, LVTs are theoretically attractive, particularly from an economic efficiency perspective, but, on the other hand, they are politically unattractive, and as McCluskey and Franzsen observe:[147]

> Despite the apparent merits and demerits of a land value tax from a theoretical point of view, the choice of the tax base is more often based on the very specific circumstances faced by the relevant taxing authority. Socio-political views, historic factors, as well as practical realities seem to be the deciding factors.

[146] As Steven M Sheffrin, 'Fairness and Market Value Property Taxation' in Roy Bahl, Jorge Martinez-Vazquez (eds), *Challenging the Conventional Wisdom on the Property Tax* (Lincoln Institute of Land Policy, 2010) 241, 249 observes, 'two individuals with equal wealth could easily have different allocations of that wealth between real property and all other assets'.

[147] McCluskey and Franzsen, above n 17, 15.

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Reforming the Western Australian state tax anti-avoidance strategy

Nicole Wilson-Rogers*

Abstract

The Australian Review of Business Taxation ("RBT")[1] provides that tax avoidance occurs where there is a misuse of the law, such as the exploitation of loopholes in the legislation, to achieve a tax outcome that was not intended by parliament.

Tax avoidance presents an unremitting challenge to the integrity of a revenue base and for tax administrators globally.[2] In Australia, tax is levied at state, territory and federal levels and consequently, tax avoidance is a problem that affects administrators at all levels of government. As a result, the tax avoidance strategy of state tax administrators can be informed by analysing the methods adopted by their counterparts in other states, territories and by the Commonwealth.[3]

This paper considers the Western Australian ("WA") state tax anti-avoidance strategy and argues that it can be strengthened in three key respects: (i) consideration should be given to adopting a uniform general anti-avoidance rule ("GAAR") based on a refined version of Chapter Seven of the *Duties Act 2008* ("Duties Act"). This should apply across the three main WA taxes: duties, pay-roll tax and land tax and be located in the *Taxation Administration Act 2003* (WA) ("WA TAA");[4] (ii) the terms of Chapter Seven should be amended and used as the basis of the new uniform GAAR. The amendments should adopt elements of Part IVA in the *Income Tax Assessment Act 1936* (Cth) ("ITAA 1936") including any further refinements adopted by the Commonwealth government, key aspects of other state and territory GAARs and two of the recommendations in the RBT;[5] and (iii) WA should enact a promoter penalty regime based on the Commonwealth promoter penalty regime in Division 290 of the *Taxation Administration Act 1953* (Cth) ("TAA 1953").

Part one of this paper analyses and discusses the current tax avoidance strategy adopted in WA. This includes a detailed discussion of the GAAR in Chapter Seven of the Duties Act. Part two advocates the implementation of the three key reform measures outlined above to enhance the WA anti avoidance strategy. Part three concludes. Notably, references to other state taxation legislation is made in the context of the ensuing discussion.

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* LLB(Hons), BCom, M Tax(U Syd). Lecturer, School of Business Law and Taxation, Curtin University of Technology.

[1] Commonwealth of Australia, Final Report of the Review of Business Taxation, A Tax System Redesigned, (Canberra, 1999) at 6.2 (c)) ("RBT").

[2] Chris Evans 'Barriers to Avoidance: Recent Legislative and Judicial Developments in Common Law Jurisdictions' [2007] UNSW Law Research Papers Paper 12, 3 at http://law.bepress.com/unswwps/flrps/art12/ states: 'tax avoidance activity, like tax evasion, is neither unique to any one country nor a purely modern problem. It has been around, in varying degrees, wherever taxes have been levied.'

[3] Notably, a discussion on Tasmanian tax reform stated that there was broad consensus that "state tax reform needs a national approach" see the Tasmanian Treasurer's Presentation to the Tax Institute (13 October 2011) at <http://www.sro.tas.gov.au/domino/dtf/dtf.nsf/LookupFiles/Treasurers-Presentation-Tax-Institute-October-2011.PDF/$file/Treasurers-Presentation-Tax-Institute-October-2011.PDF.>

[4] Rachel Tooma, Legislating Against Tax Avoidance (IBFD,2008) advocates the adoption of a uniform GAAR for state and Commonwealth taxes.

[5] RBT above n 1.

Appendices 1 and 2 draw on the recommendations made in Part two and outline (respectively) the elements that should form a WA uniform GAAR and promoter penalty regime. Although this paper is written in the WA context the suggestions that are advocated could similarly apply to other state jurisdictions that adopt a similar tax structure to WA. Observations are made throughout the paper regarding the relevance of the recommendations to other Australian states and territories

1. PART ONE: THE CURRENT STATE OF PLAY

1.1 Tax avoidance and state taxes

As noted above, tax avoidance is not a problem that is unique to Commonwealth taxes and it also presents a problem in relation to state taxes. In the WA Final Report for the Review of State Business Taxes ("Business Tax Review")[6] it was suggested that tax avoidance through: 'minimization practices and tax planning' had become accepted practice. This statement was used as a platform for proposing that a GAAR be progressed in the context of the *Stamp Act 1921* (WA):

> Legal tax avoidance through minimisation practices and tax planning have become accepted practice in the last ten years or so, to the extent that practitioners can be subjected to negligence actions for not advising clients of legal tax avoidance mechanisms.
>
> In this culture, the tax laws have become subject to intense scrutiny by persons looking for loopholes or weaknesses. When combined with the general interpretation principle that tax law should be read in favour of the taxpayer when a provision is unclear, the result is often significant revenue loss and increasingly complex law. [7]

WA has three main state taxes: duty, pay-roll tax and land tax. Duties replaced stamp duty from 1 July 2008. Unlike stamp duty, which was an instrument-based tax, duty is a tax based on transactions. The imposition of duty focuses upon two basic building blocks, ascertaining that there is a dutiable transaction[8] in respect of dutiable property.[9] The Duties Act also levies landholder duty which is duty payable on the acquisition of a significant interest in a company or unit trust that owns WA land with an unencumbered value of $2,000,000 or more.[10] A significant interest is 50% or more for unlisted unit trusts or companies or 90% or more for listed unit trusts or companies. [11]

[6] Department of Treasury and Finance – Government of Western Australia, Review of State Business taxes: Final Report (28 February 2002) http://www.finance.wa.gov.au/cms/uploadedFiles/final_report.pdf, 115. ("Business Tax Review").
[7] Ibid.
[8] Section 11 of the Duties Act.
[9] Section 15 of the Duties Act.
[10] Section 158 of the Duties Act.
[11] Section 161 of the Duties Act.

Pay-roll tax is imposed by the *Pay-roll Tax Assessment Act 2002* (WA) ("PTAA 2002") and the *Pay-roll Tax Act 2002* (WA) ("PTA 2002") on the total monthly wages paid to employees of a business.[12]

Land tax is a property tax based on the unimproved value of specified landholdings. [13] Land tax is imposed and collected by the *Land Tax Act 2002* (WA) ("LTA 2002") and the *Land Tax Assessment Act 2002* (WA) ("LTAA 2002"). Broadly, the types of land that are taxable for land tax purposes include commercial, investment, industrial and vacant land.[14] A taxpayer's main residence and properties used for primary production are generally exempt. [15]

Whilst all of these state taxes could be susceptible to tax avoidance, some commentators have suggested that tax avoidance may be less prevalent overall in relation to state taxes,[16] and in particular in relation to land tax.

However, in practice, this is a difficult proposition to substantiate as there is no current empirical evidence that supports the assertion that tax avoidance is less prevalent in relation to state taxes. Indeed a WA Productivity Commission paper: "*Directions for State Tax Reform*" provides:

> There is little empirical evidence on whether transactions-based taxes are easier to avoid and evade than *property taxes*, though there is some evidence that past loopholes allowed avoidance of substantial amounts of *conveyancing duty*. It is likely that transactions-based taxes generally will be less prone to avoidance and evasion than taxes with unobservable bases, such as Commonwealth income taxes. Nevertheless, avoidance of *franchise fees* has in the past been encouraged by interstate differences in tax rates.[17]

Tax avoidance can come in very diverse forms and whilst it is impossible to contemplate all the different types of avoidance that could occur in relation to state taxes, a brief summary of the broad types of tax avoidance activities that may occur, are suggested below.

Slater suggests that there are two basic categories of avoidance, in relation to duty.[18] The first category is designing or framing a transaction so that the desired economic result can be achieved without effecting a transaction that attracts duty.

The second broad category of duties avoidance is framing a transaction in a way that attracts an exemption or reduction of duty. For example, framing a transaction so that

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[12] The pay-roll tax base is very broad and "wages" includes superannuation payments to "employee" like contractors. See Business Tax Review above n 6, 17.

[13] Note that there are other land taxes such as the Metropolitan Region Improvement Tax, the Agricultural Protection Rate and the Perth Parking Levy. However, these are not a major source of revenue for the state and therefore they are not discussed in this paper.

[14] Business Tax Review above n 6, 44.

[15] Ibid. For example, see section 21 of the LTAA 2002.

[16] AH Slater QC 'Stamp Duty Avoidance' (2009) 38 *Australian Tax Review* 47.

[17] WA Productivity Commission, Directions for State Tax Reform (May 1998), 50 <http://www.pc.gov.au/__data/assets/pdf_file/0003/7725/statetax.pdf >.

[18] Slater above n 16.

it attracts the connected entity reconstruction exemption in Chapter Six,[19] or attempting to bring an agreement within the definition of a farm-in agreement, [20] so it will be chargeable with nominal duty if no consideration is paid or agreed to be paid. In this regard, the Business Tax Review states:

> …a number of avoidance practices have evolved from business practices or the exploitation of exemptions for purposes outside their intended application. Anecdotal evidence suggests that avoidance activity has been increasing over the last 10-15 years as property values rise and move property acquisitions into the higher end of the conveyance duty scale.[21]

In relation to pay-roll tax, avoidance could take the form of manipulating the characterisation of wages so they are classified as another type of non-taxable payment or attempting to have employees categorised as contractors.[22]

Land tax appears to be the most difficult state tax to avoid. The Business Tax Review[23] provides that land tax is one of the most efficient taxes because of the immobility of land which minimises avoidance opportunities. Furthermore, the Business Tax Review states:

> the opportunity for avoidance is somewhat controlled in the real property area where the land registration system for direct interest transfers provides a good compliance tool.[24]

However, it is suggested potential avoidance opportunities would still exist in the form of exploiting one of the many exemptions offered within the LTAA 2002.[25]

1.2 WA's current tax avoidance strategy

WA currently adopts two main strategies to combat tax avoidance activities: GAARs and specific anti-avoidance rules ("SAARs"). However, it does not currently contain a promoter penalty or mandatory disclosure regime.

There are two main GAARs in WA state tax legislation, one is contained in Chapter Seven of the Duties Act[26] and the other is contained in section 21 of the PTAA 2002. There are also more targeted GAARs (mini-GAARs) in section 265 of Chapter Six and in section 36 of the Duties Act.

There are multiple SAARs in the Duties Act, PTAA 2002 and LTAA 2002. For example, there are disaggregation provisions in section 37 of the Duties Act that prevent the splitting of transactions when they are substantially one transaction, grouping provisions in Part 4 of the PTAA 2002 that ensure related entities are

[19] For an example of avoidance (in the stamp duty context) in relation to the corporate reconstruction exemptions in the *Stamp Act 1921*(WA) see *Re Quetel Pty Ltd and the Commissioner of Stamp Duties* (Qld) 1991 91 ATC 4771.
[20] Section 13 of the Duties Act.
[21] Business Tax Review above n 6, 88.
[22] Note that employee like contractors can come within the pay-roll tax net.
[23] Business Tax Review above n 6, 48.
[24] Business Tax Review, above n 6, 88.
[25] For example, avoidance strategies may include trying to argue that land falls within one of the exempt categories such as principal place of residence exemption.
[26] Sections 267-271 of the Duties Act.

grouped for the purposes of calculating pay-roll tax[27] and claw back provisions in the LTAA 2002, to maintain the integrity of the caravan park exemption where an exemption is claimed and the usage of the land later changes.[28] Given the focus of this paper is on relocating and reforming the GAAR and introducing a promoter penalty regime, SAARs are not discussed in any further detail below.

Whether GAARs or SAARs are more effective has been the subject of widespread academic and practitioner debate. This paper does not purport to deal with this issue comprehensively, however the propositions in this paper are built upon the presumption that a GAAR is a fundamental and important part of any tax avoidance strategy.[29] Therefore, amending the GAAR is the focus of this paper, rather than addressing the question of whether a GAAR is necessary in the context of state taxes.[30] Consequently, whilst there may be SAARs in the Duties, PTAA 2002 and LTAA 2002 that require reform, this paper focuses only on the reform of the GAAR and enacting a complementary promoter penalty regime.

1.3 GAARs

1.3.1 Duties

The GAAR in the Duties Act is housed in Chapter Seven. [31] The GAAR was introduced in 2008 as part of the rewrite of the *Stamp Act 1921* (WA). There was no GAAR in the *Stamp Act 1921* (WA), although it did contain very broad anti-avoidance provisions.[32]

In explaining the introduction of Chapter Seven, the Explanatory Memorandum ("EM") to the *Duties Bill 2007* (WA) outlines the inadequacies of utilising SAARs alone to combat tax avoidance. The problems outlined include the lag between the identification of the tax avoidance practice, which results in revenue leakage and the time in which legislative amendment can be effected. The EM states:

> The Stamp Act does not contain a general anti-avoidance provision, however, it contains numerous specific provisions to deal with known avoidance schemes.

[27] See section 51-57 of the PTAA 2002.
[28] Section 39B of the LTAA 2002.
[29] RA Tooma above n 4.
[30] Some commentators argue that GAARs are not as likely to be efficacious in relation to state taxes. For example, Slater above n 16 argues:

> The essential nature of stamp duties is fundamentally different from that of the taxes for which general anti avoidance provisions were enacted and which have been effective. Those taxes – the income tax …and the value added tax – are taxes on outcomes rather than events. Income, and capital gains, are the yield or surplus from activities. GST is a value added tax, that is, on the surplus of realized price over input costs, and therefore on the net result of dealings by registrable persons. Stamp duty, on the other hand, is imposed on instruments, or now on transactions, and not on their outcomes. If the instrument or transaction chosen to secure a desired outcome is one which does not attract duty, even if that is the reason for choosing it, can it fairly be said that the use of that instrument or transaction is avoidance?

[31] See sections 267-271 of the Duties Act.
[32] See for example sections 75JDA and 76AV of the *Stamp Act 1921* (WA). Also see pages 293-294 of the Department of Treasury and Finance – Government of Western Australia, *State Tax Review, Technical Appendices* (May 2006) ("State Tax Review")

> A problem with this approach is that it relies on the Commissioner detecting the avoidance activity in the first instance, and then developing countervailing legislation. Legislating specific anti-avoidance provisions is a lengthy process and the revenue lost to the State in the interim may be substantial, unless the amendment is made retrospective (which is generally considered undesirable).[33]

This statement regarding the necessary introduction of a GAAR is supported by a substantial body of academic literature in favor of the introduction of a GAAR. The literature focuses on the need to have in place flexible anti-avoidance legislation like a GAAR, that is highly responsive to the 'evolving and chameleon-like character of tax avoidance'. [34]

Consistent with the operation of most conventionally drafted GAARs, the operation of Chapter Seven is two phased. The first phase includes determining the preconditions: scheme, duty benefit and dominant purpose and the second phase allows the Commissioner to exercise his discretion to reconstruct the transaction and determine the duty payable. Orow and Teo usefully refer to these two elements of a GAAR as the definitional and reconstructive components.[35]

1.3.2 Definitional elements of Chapter Seven

The definitional component of a GAAR identifies the characteristics of the transactions to which the GAAR is intended to apply. This definitional component can further be divided into two sub-elements: a physical and mental element. The physical element focuses on the characteristics of the scenarios to which the GAAR is intended to apply. The mental element predicates the operation of the GAAR on the finding of: 'a particular state of mind which actuated the physical transaction, for example, the sole or dominant purpose of avoiding tax.' [36]

Thus, the first step in establishing the operation of Chapter Seven is to establish the preconditions or definitional components. These elements consist of ascertaining a scheme, duty benefit and purpose of avoiding duty. The duty benefit and dominant purpose tests are contained within the definition of a tax avoidance scheme for the purposes of Chapter Seven. Once these preconditions are established the discretion in Chapter Seven is enlivened.

1.3.3 Scheme

The first precondition to the operation of Chapter Seven, is that there must be a scheme. A scheme is defined broadly and inclusively in section 267 and includes the whole (or any part of) an oral, written, express or implied trust, contract, agreement,

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[33] EM to *Duties Bill 2007(WA).* See also the State Tax Review Ibid, 295 that states:

> A problem with relying on specific anti-avoidance provisions is that when a new scheme or method of avoidance is detected, it can only be shut down by a legislative amendment. This is generally a lengthy process and unless the amendment is retrospective, the revenue to the State is lost. Further once a specific anti avoidance scheme is shut down, variations of that scheme tend to emerge that are effective in avoiding duty, until that scheme is shut down, and so on. All the while, the tax burden falls increasingly on those who are meeting their tax obligations.

[34] Nabi Orow and Eu-Jin Teo, 'Duties General Anti-Avoidance Rules: Lessons from Income Taxation' (2004) 7(2) *Journal of Australian Taxation* 251.

[35] Ibid.

[36] Ibid.

arrangement, understanding. It further includes a promise or undertaking, plan, proposal, course of action or conduct. This includes these elements whether or not they are enforceable. It also includes a unilateral scheme.

The definition substantially resembles the definition of a scheme in section 177A of the ITAA 1936. Notably, the High Court in *Hart*[37] considered similar provisions in relation to scheme in section 177A and it was confirmed that this type of definition is very broad and comprehensive. It is likely therefore, that ascertaining that a scheme exists would rarely be a matter of dispute in the context of Chapter Seven.

By being defined to include part of a scheme, it appears the definition of scheme in the Duties Act, was drafted in contemplation of overcoming the difficulties in *Peabody*[38] that were highlighted by the High Court in relation to Part IVA of the ITAA 1936. In *Peabody*[39] it was noted that part of a scheme does not constitute a scheme. Some commentators have noted that this drafting of section 267 increases the risk that the Commissioner can "drill down" to isolate specific parts of the transaction producing the benefit and argue that it is therefore tax avoidance.[40]

The transitional provisions in Schedule 3 to the Duties Act provide that Chapter Seven only applies to a scheme where at least one of the transactions, by which it is carried into effect, occurs on or after 1 July 2008.

Section 268(3) provides that it does not matter if the scheme is entered into or carried out (wholly or partly) in or outside of WA. Furthermore, it does not matter if a person that enters into the scheme is a person that is liable to pay duty.

1.3.4 Purpose and duty benefit

Several of the key definitional components of Chapter Seven are introduced through the concept of a "tax avoidance scheme". These elements include the establishment of a dominant purpose and the concept of a tax benefit. Section 268(2) states:

> For the purpose of this Chapter a tax avoidance scheme is a scheme that a person enters into or carries out -
> (a) for the sole or dominant purpose of enabling -
> i. An elimination or reduction in the liability of a person for duty; or
> ii. A postponement in the liability of a person for duty; or
> (b) when any purpose relating to the elimination reduction or postponement if the liability of a person for foreign tax is disregarded for the sole or dominant purpose of enabling -
> i. An elimination or reduction in the liability of a person for duty; or
> ii. A postponement in the liability of a person for duty.

[37] *Commissioner of Taxation v Hart* (2004) 217 CLR 216.
[38] *FCT v Peabody* (1994) 181 CLR 359.
[39] Ibid.
[40] Nick Heggert, 'Duties Act in Practice'(Paper presented at Taxation Institute of Australia WA State Convention, Busselton, 28-30 August).

Accordingly, to establish a tax avoidance scheme two elements must be identified:

- A duty benefit has been obtained in the form of a postponement, elimination or reduction in the liability of a person for duty; and
- A person that entered into or carried out the scheme had the sole or dominant purpose of enabling a duty benefit.

Notably, the concept of a duties benefit is defined very broadly to include an elimination, reduction or postponement in the liability of a person for duty. WA is one of the only states to include a postponement of liability as a tax benefit for the purposes of duties or stamp duties GAAR.

The operation of the dominant purpose test however presents some difficulties. Commentators have noted that it is not clear from the terms of the legislation whether the purpose test in section 268(2) is objective or subjective and this ambiguity is discussed in further detail below. The EM to the *Duties Bill 2007* (WA) states that the test is designed to be objective like the test prescribed in Part IVA.

Once the preconditions have been established, section 270(1) provides the Commissioner with discretion to disregard a transaction where he determines that a person has entered into or carried out a 'tax avoidance scheme' that is 'blatant, artificial or contrived.'[41] Thus, the requirements are two fold – not only must the preconditions in tax avoidance scheme be satisfied but the scheme must also be "blatant, artificial or contrived". This gives rise to questions such as can a tax avoidance scheme ever not be blatant, artificial or contrived? Are there degrees of acceptable and unacceptable tax avoidance?[42] Heggart argues that this additional requirement (of establishing that a scheme is blatant, artificial and contrived) may restrict the operation of Chapter Seven, as compared to Part IVA, because:

> A dominant purpose of obtaining a duty benefit could be argued to be insufficient if there is also a genuine commercial objective. It would be rare for such a dealing as a whole to be described as "blatant, artificial and contrived".[43]

In making a determination, section 270(3) lists six factors the Commissioner of State Revenue "must" have regard to. This tunnel of factors includes:

i. the way the scheme was entered into or carried out;
ii. the form and substance of the scheme, which includes the legal rights, obligations, economic and commercial substance of the scheme;
iii. when the scheme was entered into and the length of the period during which the scheme was (or is to be) carried out;
iv. any change to a person's financial position, or any other consequence that has resulted, or may reasonably be expected to result, from the scheme;

[41] Section 270(1) provides: "Ïf the Commissioner decides that a person has entered into or carried out a tax avoidance scheme that is of a blatant, artificial or contrived nature the Commissioner may disregard the scheme."

[42] N Wilson-Rogers, "Coming out of the Dark? The Uncertainty that Remain in Respect of Part IVA. How does recent tax office guidance help?" *eJournal of Tax Research* (2006) Vol 4 no1, 25-60.

[43] Heggert above n 40.

v. the nature of the connection (business, family or other) between the person that entered into or carried out the scheme and any other person; and
vi. the circumstances surrounding the scheme.

Whilst these factors appear to replicate the eight factors that are contained in Part IVA, it is not stated that these factors relate specifically to establishing dominant purpose. Arguably, these could also apply in determining if a scheme was 'artificial, blatant and contrived' and other undefined factors could be utilised to establish dominant purpose.

1.3.5 Reconstructive element

Section 270(2) provides the Commissioner with a broad reconstructive power to determine the duty that would have been (or could reasonably be expected to be payable) "but for" the scheme and give effect to that determination by making an assessment or reassessment under the WA TAA. [44] This involves establishing a counterfactual or alternative postulate, by hypothesizing what would have occurred if the scheme was not entered into or carried out and the duty that therefore would have been payable.

Section 271 of the Duties Act requires that an assessment notice issued pursuant to section 270 must contain, or be accompanied by, a statement of the reasons for decision and grounds for the duty determination.

1.3.6 Pre Transaction Determination

The WA Duties Act is the only duties or stamp duties legislation that contains a facility for taxpayers to request the Commissioner to determine if Chapter Seven would apply to a scheme. [45]A request must be made in the approved form.[46] The Commissioner can request the person who has made the request to provide any information needed in order to identify the transaction to which the scheme relates. Section 34(1) of the WA TAA provides a taxpayer with the facility to object against a pre-transaction decision.

1.3.7 Judicial clarification

At the date of writing this paper the WA GAAR has not been litigated and therefore, there is no judicial clarification on the scope of these provisions. It is likely that the case law on Part IVA would provide authoritative guidance on the interpretation of Chapter Seven, given the close resemblance in drafting that Chapter Seven has to elements of Part IVA, coupled with the fact that the stated intention in the EM is that the operation of Part IVA was used as a model in drafting Chapter Seven.

Set out below is a diagrammatical overview of the operation of Chapter Seven.

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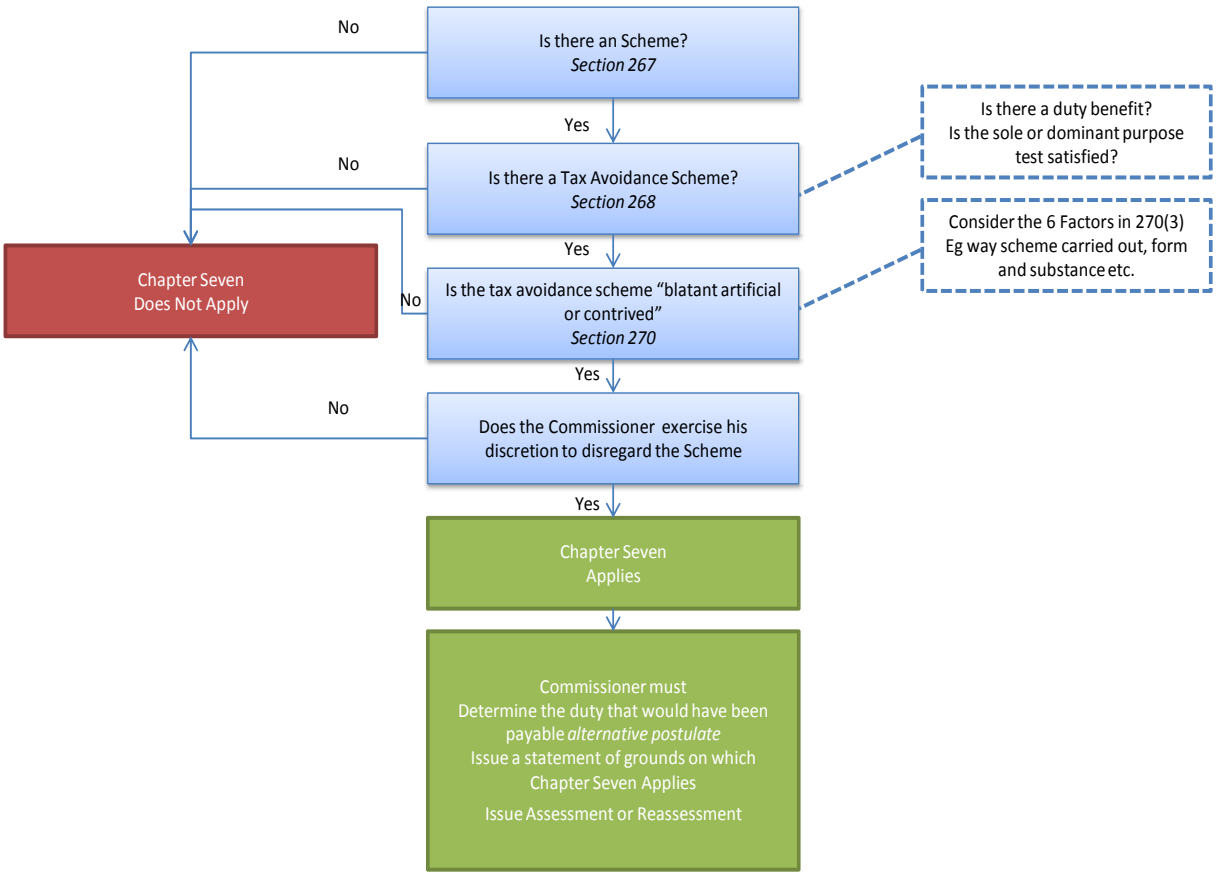
[44] Section 15 of the WA TAA.
[45] Sections 269(1)-(8) of the Duties Act.
[46] The approved form is found on the Department of Finance website at: http://www.finance.wa.gov.au/cms/uploadedFiles/_State_Revenue/Duties/Forms/Tax_Avoidance_Scheme_-_Pre-Determination_Of_Section_270_Decision.doc



1.3.8 Section 265

In addition to Chapter Seven, the connected entity exemption in Chapter Six of the Duties Act, also contains a mini- GAAR. Section 265 provides that the Commissioner may revoke an exemption where it is part of a scheme or arrangement entered into or carried out by a person for the purpose of avoiding or reducing duty (or another tax) on a transaction, licence transfer or acquisition.

This resembles Chapter Seven but specifically deals with the exploitation of the connected entity exemption. It also does not define 'scheme' or 'purpose'.

Accordingly, it is unclear if the same tests and definitions that are applied in Chapter Seven for determining a scheme, would be applicable. It is also not clear if the purpose test in section 265 is subjective or objective.

1.3.9 Section 36

Section 36 of the Duties Act details how to calculate the unencumbered value of property and also contains a mini-GAAR. Section 36 provides that the unencumbered value of property is the value without having regard to any scheme that results in the reduction of value of the property and where the dominant purpose of any party to the scheme was reduction of the value of the property. A note to the section gives the example of B wanting to purchase land owned by A. But before the purchase A and B enter into a non-commercial fifty year lease so B doesn't pay rent under the lease. This devalues the land (as taking into account the non-commercial lease the land value is impaired). However, pursuant to section 36 the unencumbered value will be calculated without regard to the lease as it was entered into with the dominant purpose of reducing the value of the property. Again the terms 'scheme' and 'dominant purpose' are not defined in relation to section 36 and it is unclear if the definitions in Chapter Seven will apply.

1.3.10 Pay-roll tax

The PTAA 2002 contains a GAAR in the form of section 21. Section 21 provides that if a person is a party to a "tax reducing arrangement" the Commissioner can: disregard that arrangement, determine that a party to the arrangement is an employer for the purposes of the Act; and determine that any payment made under the arrangement is wages paid or payable for or in relation to the services performed by the worker.

Where the Commissioner makes such a determination, he must serve a notice to that effect on the person and set out in the notice the grounds on which the Commissioner relies and the reasons for making that determination.

The key phrase in section 21, "tax reducing arrangement" is defined in the Glossary to the PTAA 2002 as including*:*

> any arrangement, transaction or agreement, whether in writing or otherwise under which a natural person (the worker) performs, for or on behalf of a second person, services for which any payment is made to a third person related or connected to the worker; and
>
> which has the effect of reducing or avoiding the liability of any person to the assessment, imposition, or payment of pay-roll tax (whether or not that is the only effect of the agreement).

In this regard, it mimics the broad and inclusive definition of a tax avoidance scheme in Chapter Seven but is more targeted towards pay-roll tax specific circumstances.

Interestingly, unlike Chapter Seven there is no requirement that a person entering into the scheme had a dominant purpose of avoiding tax, it is only necessary that the arrangement 'has the effect of' reducing liability. It is unclear why this lower threshold is applied when ascertaining the application of the GAAR in the pay-roll tax sphere. In this regard s 21 is similar to the second limb of section 165-5 the general anti avoidance rule in the GST Act that provides that the provision can operate where the principal effect of the scheme is tat the avoidaer gets a GST benefit either directly or indirectly.

1.3.11 Land tax

The LTAA 2002 does not contain a GAAR.

2. PART TWO: OVERALL REFORM STRATEGY

Whilst the WA anti-avoidance framework is comprehensive, as with any strategy it is capable of reform. This paper advocates three main reform strategies in relation to the WA tax avoidance framework that could be undertaken to strengthen WA's anti-avoidance framework:

- a uniform GAAR should be introduced to apply across the duty, pay-roll tax and land tax acts;[47]
- the current duties GAAR in Chapter Seven should form the basis of the uniform GAAR. However, Chapter Seven should be refined to adopt some of the key features of Part IVA, recommendations of the RBT, recent Government announcements to enhance the operation of Part IVA and features of GAARs in other state and territory tax legislation; and
- a promoter penalty regime based on the Commonwealth regime should be enacted for WA state taxes.

Each of these reform strategies are discussed in detail below. Notably, several of these recommendations could have application in other states or territories that have a similar legislative structure to WA.

2.1 Reform Strategy One: A uniform GAAR to apply across all state taxes

As discussed above in part two, there are several different GAARS contained in state tax legislation. The Duties Act contains a broadly drafted GAAR in the form of Chapter Seven and two other mini-GAARs in sections 265 and 36 of the Duties Act. The pay-roll tax legislation contains a more targeted GAAR in the form of section 21 and there is no GAAR for land tax purposes.

Whilst the GAARs adopted for pay-roll tax and duties purposes have similarities, they are drafted differently and therefore have potentially different operations. This inconsistency arguably creates complexity and additional compliance burdens for taxpayers and their advisors, as they need to familiarise themselves and apply different avoidance tests across each of the taxes in the state context.

This difficulty or inconsistency is exacerbated by the mini-GAARs in section 36 and 265 the Duties Act. This duplication of GAARs within the same Act gives rise to questions regarding whether there is some difference between the purpose tests in the different sections. Alternatively, it may represent to taxpayers a degree of uncertainty on behalf of the drafters of the legislation as to the effectiveness of the main GAAR in

[47] R Tooma above n 4 advocates the adoption of a uniform GAAR across all states, territories and Commonwealth taxes.

Chapter Seven. Furthermore, it could lead to the GAAR in Chapter Seven being under-utilised or rendered ineffective by the proliferation of superfluous mini-GAARs.

Young outlines the difficulties in relation to having two GAARs in one Act and looks at the interaction of Chapter Seven and section 265 in the Duties Act. He suggests that section 265 would prevail over the GAAR in Chapter Seven according to the principle of statutory interpretation that specific legislative provisions should apply over general. Relevantly, he states:

> The second type of specific provision is of the kind found in section 265 where the Commissioner may revoke an entity reconstruction exemption if he determines the transaction as part of a scheme as described in the section. This is a true anti-avoidance provision... If the proscribed scheme exists the Commissioner may revoke, otherwise the exemption remains available under the provisions of Chapter 6. I submit that this kind of specific provision leaves no room for the general provisions to operate so far as the exempted transaction is concerned. Parliament has expressed the particular circumstances under which the concession may be revoked. It must be taken to have intended that it could not be revoked, or disregarded, under the different and more broadly expressed provisions of Chapter 7. In my submission for this kind of provision there is a conflict between the specific and the general. [48]

Consolidating the GAARs into a uniform GAAR will reduce conflict between inconsistent mini-GAARs and Chapter Seven. It will also ensure that the broad terms of a GAAR are not fettered by other more limited GAARs.

Introducing a uniform GAAR for state taxes could also reduce the proliferation of SAARs within the various pieces of state tax legislation. In the GAAR Discussion Paper[49] it was stated:

> making greater use of the GAAR could simplify the law by reducing the need for taxpayers to be familiar with many complicated SAAPs [statutory ant avoidance provisions] and reduce the overall volume of the law.[50]

Accordingly, it is recommended, that in order to enhance the effectiveness of the state tax avoidance strategy and reduce the proliferation of SAARs, increasing the complexity of the legislation a uniform GAAR (based on a refined version of Chapter Seven of the Duties Act as discussed below) should be enacted that applies across all state taxes. A uniform GAAR enhances administrative simplicity for taxpayers and their advisers, contributes to a reduction in compliance costs for taxpayers and avoids conflicts between inconsistent GAARs.

The unique nature of a GAAR makes it particularly amendable to application across different taxes. Tooma argues that tax avoidance legislation is one of the unique parts of taxation law that provides its own incentives for uniformity. [51] This is because a

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[48] Grahame Young, *'Duties Act 2008: Difficult and Unresolved Issues'* (Paper presented at Corporate and Commercial Law Symposium Seminar A The Duties Act: 2 Years On, Perth, 11 February 2011).

[49] Australian Government, *Improving the operation of the anti-avoidance provisions in the income tax law Discussion Paper* (18 November 2010) ("GAAR Discussion Paper).

[50] GAAR Discussion Paper Ibid.

[51] R Tooma above n 4.

GAAR by its nature must be broad, amorphous and generic so that it is equipped to deal with unforeseen, moving and diverse activities.

Pagone argues that a GAAR occupies a unique role in any taxing Act by attempting to target activities that are not caught or contemplated by the operative provisions.[52] In this regard, a GAAR functions to supplement the operative provisions. Thus, it is argued that a GAAR modeled on an amended Chapter Seven could successfully apply across all state taxes. This is because the essential elements of the GAAR identify broad characteristics or attributes that could be applied regardless of the type of tax involved. This is evident in the similar design and terminology adopted in Part IVA, in the income tax context, Division 165 in the Goods and Services Tax context and the various state and duties GAARs.

Furthermore, a GAAR applying to all state taxes would also help to protect the integrity of the land tax base, which does not currently contain a GAAR. Whilst incidences of the avoidance of land tax may be less common, amending the GAAR to be rehoused in the TAA and thereby extended across all taxes would have a strong deterrent effect in relation to any potential avoidance of land tax and any potential abuses of the wide exemptions provided from land tax. Notably, the Australia's Future Tax System review suggested a greater reliance on land tax and therefore, extra protection of the integrity of this tax base makes sense in the context of these recommendations. Queensland has included a GAAR in their *Land Tax Act 2010 (Qld)* [53] signifying a perceived need for avoidance provisions in the context of land tax, even though the overall incidence of avoidance may be lower. The idea of a GAAR for land tax was discussed and advocated in the State Tax Review.[54]

Having a uniform GAAR that applies to all state taxes was also discussed in the WA State Tax Review:

While it would be preferable for a general anti-avoidance provision to be located in the TAA and apply to all State taxes, the diverse range of taxes covered by the TAA and the contentious matters it may be required to address or remedy may make it impractical for such a provision to be effectively drafted.[55]

However, it was further suggested that the issue of a uniform GAAR should be revisited after the model for a duties GAAR had been developed and further consideration could be given to whether such a provision could apply to land and pay-roll tax.

A uniform GAAR should be housed in the WA TAA. The WA TAA provides for the administration and enforcement of the legislation pertaining to state taxation. The provisions of the WA TAA apply to all state taxes and relevantly the Duties Act, LTA 2002, LTAA 2002, the PTA 2002 and the PTAA 2002. Furthermore, the WA TAA already provides a blueprint for uniform provisions across state taxes, with uniform penalty provisions contained in Division 3.

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[52] A Blaikie, *Part IVA Where are we at?* The Tax Specialist (2008) 17(2) 54 and 55. GT Pagone, 'Part IVA the General anti avoidance provision in Australian taxation law' (2003) 27(3) *Melbourne University Law Review* 770.

[53] See Chapter 8 (sections 64-69) of the *Land Tax Act 2010 (Qld)*.

[54] State Tax Review above n 32.

[55] State Tax Review above n 32, 305.

WA would not be the first state to adopt a uniform GAAR; uniform GAARs that are applicable to all state taxes are adopted in the *Taxation Administration Acts* of the Australian Capital Territory,[56] Tasmania[57] and South Australia. [58] In this regard the Hansard to the Bill in introducing the uniform provisions in Tasmania it is stated that the uniform GAAR provides a: 'broad and **consistent** approach to tax avoidance across State Taxes.'[59] (emphasis added)

Interestingly, even in these jurisdictions GAARs have also been maintained in the pay-roll tax acts. It is unclear how these two GAARS would interact and it is submitted that it may be unnecessary to have both. [60]

Arguably, a broadly drafted GAAR (like that contained in Chapter Seven) could deal with the scenarios contemplated by section 21 of the PTAA 2002. For example, section 21 allows the Commissioner to disregard an arrangement, determine that a party is an employer for the purposes of the PTAA 2002 or determine that any payment is wages and arguably, all of these reconstructions would be possible for the Commissioner under an appropriately worded GAAR.

Nevertheless, it is likely that as a result of pay-roll tax harmonisation section 21 may need to remain. Pay-roll tax harmonization was announced on 29 March 2007 to reduce the administrative and compliance burdens of taxpayer and achieve a 'seamless national economy'. One of the aims of harmonisation is to enact uniform legislation.

However, it could still be supported by a uniform GAAR in the TAA and utilised if the pay-roll tax GAAR was construed and interpreted in a narrower manner by the judiciary, who may do so because of the potentially broad use of the terms 'have the effect that'. Alternatively, a repeal of the pay-roll tax GAAR could be considered as part of the harmonization process for those states or territories that adopt a uniform GAAR.

2.2 Reform Strategy Two: Refining Chapter Seven

One of the most effective weapons in a tax administrator's arsenal is a broadly drafted GAAR and therefore, reforming and refining the terms of the GAAR should remain a priority for tax administrators.[61] The ongoing importance of maintaining an efficiently functioning GAAR has been recognized in the GAAR Discussion Paper which considers improving the operation of anti avoidance provisions in the income tax law.[62]

The essential elements of a uniform GAAR could be based on the elements contained in Chapter Seven. However, arguably the terms of Chapter Seven should be amended to draw upon the key elements of Part IVA, existing state and territories GAARs,

[56] Section 8 of the *Taxation Administration Act 1999* (ACT).
[57] Division 3A (section 113A-113F) of the *Taxation Administration Act 1997* (Tas).
[58] Part 6A of the *Taxation Administration Act 1996* (SA).
[59] Hansard to the *Statutes Amendment (Land Holding Entities and Tax Avoidance Schemes) Bill*.
[60] Sue Williamson and Ada Lam, 'Duty Anti-Avoidance provisions' (Conference paper presented at the 11th Annual States' Taxation Conference 28-29 July 2011), 1.
[61] See the New Zealand and South African reviews into GAAR and the recent UK inquiry into adopting a GAAR. Tooma above n 4.
[62] GAAR Discussion Paper above n 49.

recent announcements by the Commonwealth government regarding proposed amendments to Part IVA and the RBT recommendations to form the uniform GAAR.

2.2.1 Restructure

The first amendment that should be made to Chapter Seven is to re-structure the section, so it adopts a more intuitive and logical format. It is suggested that to achieve this the structure of the uniform GAAR should be more closely aligned to Part IVA. It is suggested that such a model would ensure that the key elements of the GAAR are more explicitly highlighted. The elements (and order) in which the uniform GAAR should appear include a:

- Statement of the objective of the GAAR;
- Note establishing the precedence of the GAAR over other provisions;
- Definition section;
- Statement establishing dominant purpose;
- Reconstructive provision;
- Clarification as to the administrative requirements in relation to applying the GAAR;
- Statement of the procedure of the applying for and the effect of Pre Transaction Rulings; and
- Set of Onus Provisions.

Each of these elements are discussed in further detail below.

2.2.2 Objects Section

It is suggested that a uniform GAAR should contain an objects section clarifying the intended purpose and operation of the GAAR. An appropriately worded objects section may assuage the concerns of taxpayers that the GAAR could be given an interpretation that is too broad and would impede legitimate business planning. It could also function to confirm that the uniform GAAR must be considered in light of the operative provisions of the various Acts to which it would apply (pay-roll, duty and land tax). This would mean it would not be applied where a choice was offered by the Act, however it may continue to apply if circumstances were deliberately orchestrated to take advantage of that choice. Several of the GAARs in other states contain objects clauses. For example, South Australia[63] , Tasmania[64] and Queensland[65] have objects clauses that provide the purpose of the GAAR is to deter artificial, blatant or contrived schemes to reduce or avoid liability for tax.

Recommendation 6.1 of the RBT[66] also suggested that Part IVA should contain an objects clause detailing that Part IVA would be applied in a manner that supported the structure and underlying policy reflected in objects clauses in other parts of the income tax law. The reason for the recommendation was that this statement of policy would confirm when the GAAR could be applied and reduced a perception that valid

[63] Part 6A of the *Taxation Administration Act 1996* (SA).
[64] Section 113A of the *Taxation Administration Act 1997* (Tas).
[65] See section 40A of the *Taxation Administration Act 1996* (Qld).
[66] RBT above n 1.

business practices could be subject to the GAAR. Notably, the recently released Exposure Draft proposing changes to Part IVA suggests that an objects clause should be inserted to confirm that Part IVA is intended to counter schemes that have the requisite tax avoidance purpose and can apply to schemes that are steps within or towards other schemes. The proposed objects Clause 177A states:

> The object of this Part is to counter schemes (including schemes that are steps within or towards other schemes) that are entered into or carried out with an objectively ascertainable purpose of reducing th liability of a taxpayer to tax or withholding tax.[67]

One of the difficulties with inserting an objects clause for a uniform WA GAAR is that no other provisions in the WA TAA contain an objects clause. However, given the potentially draconian effect of a GAAR and the amorphous and indeterminate nature of some of the concepts utilised, perhaps this type of provision may warrant unique treatment in this regard.

Interestingly, the phrase 'blatant, artificial and contrived' is currently contained in section 269 of Chapter Seven. Interpretation of this phrase is problematic and gives rise to questions such as what factors should be taken into account when determining if a scheme is blatant, artificial or contrived? This is primarily driven by the fact that the terms are inherently subjective. For example, in relation to when a practice can be labeled as artificial, Professor Parsons states: 'In any case what is artificial at one time may become natural when it is generally practiced.'[68]

Accordingly, it is suggested that like Part IVA, the text of Chapter Seven should not contain the terms 'blatant, artificial or contrived'.

2.2.3 Precedence of the GAAR

The next element a uniform GAAR should contain is a statement that the GAAR has precedence over the other provisions in the PTA 2002, PTAA 2002, LTA 2002 and LTAA 2002.

Sections 177B of Part IVA, 113(2) of the Tasmania *Taxation Administration Act 1997* and 432(2) of the Queensland *Duties Act 2001* contain provisions to the effect that the operation of the GAAR is not limited by the sections of any other acts. However, Chapter Seven does not currently contain any such provision.

It is important that WA adopt a provision like this in its uniform GAAR, to ensure the efficacy of the GAAR and that it is not impeded by other provisions of the Act. It will also mean that any of the more limited mini-GAARs (if they are retained) for example, sections 265 and section 36 of the Duties Act can co-exist with, but are subsidiary to, the uniform GAAR.

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[67] Exposure Draft for *Tax Laws Amendment (2013 Measures No.1) Bill 2013: General anti-avoidance rules* http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/General-anti-avoidance-rule *at* 20 November 2012.

[68] R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985), 84, paragraph 16.55. Professor Parsons was considering the terms 'blatant, artificial and contrived' in relation to Part IVA.

2.2.4 Definition Section

For ease of use and clarity, all the definitions for the uniform GAAR should be located together in a definitions section. This would include a definition of 'scheme' and 'foreign tax'.

In relation to the concept of a scheme, it is suggested that the broad definition of scheme in section 267 of the Duties Act (discussed above) be maintained entirely in a uniform GAAR. This is the common definition in most GAARS and has also been drafted to overcome the difficulties of *Peabody.*[69]

The definition of 'foreign tax' should also be maintained from section 268. This definition will be utilised in the uniform GAAR when defining dominant purpose, to state that a purpose to avoid foreign tax is disregarded. Foreign tax includes any tax duty or impost under a Commonwealth, state, territory or foreign country's law.

2.2.5 State Tax Benefit

Likewise, for clarity, a separate definition of state tax benefit should be inserted into the uniform GAAR instead of contained within the definition of a tax avoidance scheme. The concept should be defined to be a "state tax benefit' and could be based on the current definition of a duty benefit. Therefore, it could be defined as a reduction, elimination or postponement of state tax. Further work and consultation would be needed in this regard to ensure that such a definition was broad enough to encompass all the types of benefits that could arise in the various state tax contexts.

2.2.6 Statement as to Dominant Purpose

It is suggested that the uniform GAAR should outline that a participant in the scheme needs a dominant purpose of obtaining a state tax benefit. However, it is suggested that the current purpose provisions contained in Chapter Seven should be substantially amended.

The first pivotal amendment is a statutory clarification that the purpose is objective. Commentators have remarked that it is not currently clear from Chapter Seven if the purpose test is objective or subjective. [70] It is arguable that the existing test is objective, given the onus is on the Commissioner to have regard to the factors enumerated in section 270(3) of the Duties Act when making a determination under

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[69] *FCT v Peabody* (1994) 181 CLR 359.

[70] Williamson and Lam above n 60, For example Heggart, above, n 40 notes the ambiguity in relation to whether the test in the Duties Act is subjective or:

> A tax avoidance scheme is defined in subsection 268(2) to mean a scheme that a person enters into or carries out for the sole or dominant purpose of [obtaining a duty benefit. This appears to be a subjective test of the person's actual purpose. Arguably, it is more difficult for the Commissioner to demonstrate the subjective purpose, as opposed to the objective purpose. However, it should be recalled that under subsection 37(2) of the TAA, when objecting, the onus is on the taxpayer to establish that an assessment or decision by the Commissioner is incorrect.

Chapter Seven and having regard to the statement in the EM. However, in order to overcome any arguments to the contrary this section should be redrafted for the purposes of the uniform GAAR. This could be achieved by rewording the uniform GAAR to utilise the introductory words in Part IVA, that is:

> it would be concluded that the person or one of the persons who entered into or carried out the scheme did so for the purpose of enabling the taxpayer to obtain a state tax benefit.

Furthermore, unlike Chapter Seven, Part IVA provides that dominant purpose is ascertained by having regard to the specifically enumerated factors in section 177D(b). It is suggested that an exhaustive list of factors will clearly signal that the test is objective. In this regard Tooma suggests that a dominant purpose test should be exhaustive rather than inclusive, as an inclusive list may invite the judiciary to impose limits on the operation of the test.[71]

Therefore, a further statutory clarification should be made to Chapter Seven by moving the factors in section 270(3) to the purpose provisions, so it is clear that these are the only factors to be taken into account when applying the dominant purpose test in Chapter Seven. Arguably, this is the function of these factors rather than as factors to be determined in ascertaining if a scheme is 'blatant, artificial or contrived.'

Interestingly, Victoria has adopted a GAAR[72] that does not require a conclusion as to dominant purpose. The Victorian GAAR can apply where the purpose or effect of the scheme is to reduce duty. Whether there should be a purposive component to a GAAR is a matter of significant debate. Orow and Teo state:

> Whether and the extent to which purpose should play a role in the characterization and identification of transactions for the purposes of the application of general anti-avoidance rules is a difficult question of policy, on which there is much disagreement. The principal source of difficulty derives from the fact that tax purposes and commercial purposes are not necessarily mutually exclusive, and that tax purposes are common to both tax planning and tax avoidance.[73]

Some commentators have argued that the absence of a purpose element may result in the GAAR being read down, as it was in relation to s 260 of the ITAA 1936, the predecessor to Part IVA.[74] Alternatively, it could result in the GAAR being given a wider interpretation than is desirable.

On this basis, it is suggested that the adoption of the Victorian model may not be beneficial and instead the existing purpose provisions should be maintained subject to clarification that they are objective, by adopting the wording utilised by Part IVA.

It is suggested that the provision is also maintained that a foreign tax avoidance purpose is to be disregarded when ascertaining dominant purpose. The EM to the

[71] Tooma above n 4.
[72] Part 6 of the *Duties Act 2000* (Vic).
[73] Orow and Teo above n 34.
[74] Slater above n 16.

Duties Bill 2007 clarifies that this will mean if a person entered into a scheme primarily to avoid foreign tax, for example a capital gains tax liability, it would be ignored in determining the sole or dominant purpose test in Chapter Seven.[75]

2.2.7 Reconstruction

Under section 270(2) the Commissioner must determine the duty that would have been payable but for the scheme. It is likely this is an objective test. In the income tax context a recent Full Court decision of *RCI Pty Limited v FCT* [76] confirmed that the question is objective:

> ..the statutory question is one for objective enquiry and determination – what the taxpayer might reasonably be expected to have done if it had not entered into the scheme – and the answer to that question is more likely to be found in the underlying or foundation material before the Court than in any evidence led by the taxpayer as to what it might have or might not have done; or in its failure to lead any such evidence.

Ascertaining this hypothetical in the Part IVA context has been labeled as the alternative postulate or the counterfactual and this element of Part IVA has resulted in several cases[77] litigating this issue. Recently this has been the impetus for the Commonwealth government's recent announcement to amend Part IVA. On 1 March 2012 the government announced that it would amend Part IVA so that it would better protect the integrity of Australia's tax system. The announcement made reference to recent cases where the taxpayer had argued that they did not obtain a tax benefit because they would not have entered into an arrangement that attracted a higher tax burden. The announcement makes reference to examples such as the fact that they could have entered into another scheme that avoided tax, deferred their arrangements or done nothing at all.[78] Notably, on 16 November 2012 an Exposure Draft was released suggesting amendments to Part IVA to ensure that those deficiencies were addressed. The stated aim of the amendments included to ensure:

- that the dominant purpose test in section 177D is maintained as the pivot of Part IVAs operation;
- section 177C, that defines a tax benefit is construed in a way that relates to the dominant purpose test;
- when a conclusion that a tax benefit has been obtained is dependent on a reconstruction of what would have happened absent the scheme, this inquiry focuses on the ways in which a taxpayer may reasonably be expected to

[75] Notably, the proposed recent amendments to Part IVA are drafted in a manner that ensures that only the non-tax effects of those schemes are looked at. This appears to already be achieved by the existing Duties GAAR in Chapter Seven.

[76] *RCI Pty Limited v FCT* [2011] FCAFC 104.

[77] For recent examples of disputes that involved the alternative postulate (amongst other issues) see *RCI Pty Limited v FCT* [2011] FCAFC 104 and *Yip v FCT* 2011 ATC 10-214. Also see cases such as *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134; *Noza Holdings Pty Ltd v FCT* [2011]FCA 46.

[78] Press release Hon Mark Arbib 1 March 2012 "Maintaining the Effectiveness of the General Anti-Avoidance Rule".

> achieve the *same non-tax effects* in connection with the scheme and to ensure that the taxation implication of those alternatives are not considered.[79]

Indeed, this issue involving the counterfactual and ensuring the primacy of the dominant purpose test also impacts establishing the application of the GAAR in the state tax context, as arguably, the counterfactual could embody a broad set of circumstances such as, choosing an alternative transaction to enter into. Furthermore, if the quantum of duty is sufficiently significant, it could involve the parties not proceeding with the transaction or alternatively, altering or varying the terms of the transaction that could result in a lower impost of duty.[80] Issues could further arise where more than one alternate postulate exists.[81] Young states:

> Chapter 7 aside it is not for the Commissioner to decide that a taxpayer ought to have chosen to enter into another dutiable transaction. The problem for the Commissioner under Chapter 7 is that if the taxpayer chose to enter into a particular transaction it may be difficult for the Commissioner to reasonably predicate that the taxpayer would have entered into a transaction resulting in significant and unwelcome assessments of duty – the taxpayer may have chosen some other transaction or not have proceeded at all or proceeded only on other commercial terms which would have resulted in a lesser amount of duty being payable, for example by realizing the consideration.[82]

In this regard, Recommendation 6.4 of the RBT suggested amending Part IVA to ensure that a person could not argue that nothing would be done if the scheme was not entered into or carried out. The remedy suggested was to ensure that the counterfactual reflects the commercial substance of the arrangement, so that if the scheme involved the sale of property, the counterfactual must also be constructed on the presumption that the sale of property would have occurred. This is reflected in the recently announced proposed reforms to Part IVA.[83] Given the potential impact on the GAAR in the state tax context, WA should monitor the amendments to Part IVA and depending on the outcome contemplate amending the state tax GAAR to assert that it must be assumed in formulating the counterfactual that the underlying transaction (sale of business or land) would have taken place.

2.2.8 Administrative Statement

The uniform GAAR should maintain section 271 in Chapter Seven, to the effect that the Commissioner should provide a statement of reasons for making a determination. This affords the taxpayer their right to be heard and ensures transparency in the process of administering the GAAR.

It would also be useful for the uniform GAAR to adopt a declaratory provision like section 40E of the South Australian *Taxation Administration Act 1997* detailing the date the liability to pay an amount of tax avoided would arise. Section 40E provides liability arises on the date the amount of tax avoided would have been made payable, if the tax avoidance scheme had not been entered into or made. Accordingly, section

[79] Exposure Draft above n 67.
[80] G Young above n 48.
[81] Wilson-Rogers above n 42 and PSLA 2025/24 paragraph 73.
[82] G Young above n 48.
[83] Exposure Draft above n 67.

40E details that a tax default is taken to have occurred on the date the amount of tax avoided would have been payable, if the tax avoidance scheme had not been entered into. This type of declaratory provisions would assist with ascertaining interest and penalties.

2.2.9 Onus provisions

Another significant difference between Chapter Seven and Part IVA are the onus provisions. Whilst the onus of proof at the objection level for state taxes is with the taxpayer, this reverses at the appeal level to the Commissioner of State Revenue.[84] In relation to Commonwealth taxes the onus remains with the taxpayer to prove an assessment is excessive. It is suggested that provisions be enacted to ensure the onus remains with the taxpayer in an appeal in relation to the GAAR, otherwise this leads to the anomalous result that, at the objection phase the taxpayer needs to prove elements of the GAAR and this is then reversed to the Commissioner on appeal.

2.2.10 Other Issues

Another pivotal reform strategy would be the development of administrative guidance on the way in which the GAAR in Chapter Seven will be administered. This could be based on the format of PS LA 2005/24.[85] PS LA 2005/24 contains comprehensive guidance designed to assist revenue officers who are applying a Commonwealth GAAR. PS LA 2005/24 details the operation and administration of Part IVA. Such guidance could include a discussion of the procedures to be established for the exercise of the GAAR.

A suggestion as to the wording and structure of the uniform GAAR is contained in Appendix A.

2.3 Reform Strategy Three: Adoption of a Promoter Penalty Regime

The third reform strategy, it is suggested WA should adopt, is the introduction of a promoter penalty regime for state taxes. Broadly, a promoter penalty regime functions to penalise those entities that design, market or promote avoidance schemes. Therefore, it is both complementary and supplementary to a GAAR.

Currently, the Commonwealth utilises a promoter penalty regime in Division 290 of the TAA 1953. [86] This regime is discussed below.

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[84] Section 37(1) of the TAA 2003 states that the onus of establishing that an assessment or decision to which an objection relates is invalid or incorrect lies on the taxpayer. Notably, this reform measure was suggested in the State Tax Review above n 32 at page 66.It was stated: 'The Interim Report noted that a high priority should be attached to reinstating the onus ofproof on taxpayers for appeals under the TAA, subject to further consultation with the SAT in Stage 2 of the Review.'

[85] ATO, PS LA 2005/24 *Application of General Anti Avoidance Rules.*

[86] This regime received royal assent in Australia in 2006. Victoria also has limited provisions to prosecute promoters in sections 69D and 89J of the Duties Act 2000(Vic) both entitled 'Misleading Information'. These provisions are in respect of transfer and landholder duty. Broadly, these sections apply to a person who is employed or concerned in the preparation of an instrument (that evidences a dutiable transaction) or provides advice regarding the form of the transaction and fails to include in the instrument material data which would effect the liability of a person to duty.

2.3.1 Reasons for the Introduction of a Promoter Penalty Regime

There are three compelling reasons for the adoption of a promoter penalty regime for state taxes in WA:

- to act as a disincentive or deterrent to tax advisers in relation to creating or promoting tax avoidance schemes in respect of state taxes;
- to create equity in the treatment of taxpayers who enter into tax avoidance schemes and the advisors that encourage entry into the scheme; and
- to create consistency between the obligations of tax advisers in respect of state and Commonwealth taxes.

2.3.2 Deterrent Effect

The adoption of a promoter penalty regime would have a powerful deterrent effect for the promotion of tax avoidance or tax evasions schemes in the context of state taxes. A properly designed promoter penalty regime creates firm consequences for advisers in promoting tax avoidance. Evans provides that promoter penalty regimes are "reactive and punitive" but can also act as a significant deterrent to those who seek to market abusive tax schemes." [87]By acting as a pre-emptive strike on tax avoidance, a promoter penalty regime helps reduce the design and marketing of tax avoidance schemes.

Tooma further suggests that promoter penalty regimes address the "supply side" of impermissible tax avoidance schemes which may improve taxpayer certainty.[88]

2.3.3 Equity

The WA TAA contains rigorous penalties for taxpayers that enter into tax avoidance schemes[89] it is anomalous and inequitable that there are no corresponding penalties for the advisers that design and promote these schemes. This "asymmetry" in the treatment of advisers and taxpayers was one of the reasons for the introduction of a promoter penalty regime in the context of Commonwealth taxes. The EM to the *Tax Laws Amendment (2006 Measures No. 1) Bill 2006* provides:

> 3.3 Currently, there are no civil or administrative penalties for the promotion of these schemes, with the result that promoters can obtain substantial profits while investors may be subject to penalties under the TAA 1953. This represents a significant asymmetry in risk exposure.
>
> 3.4 Furthermore, the Commissioner of Taxation (Commissioner) cannot currently take legal action to stop the promotion of tax schemes. It is possible to warn investors about the risk that tax benefits will not be available, but educational initiatives have limited 'real time' impact. In contrast, the 'real time' remedies of injunctions and voluntary undertakings in this Bill can stop the promotion of schemes before investors participate.

[87] Evans above n 2.
[88] Tooma above n 4.
[89] Sections 26 to 30 of the WA TAA.

2.3.4 Consistency

It is anomalous that a promoter can be liable for designing and marketing tax avoidance schemes at the Commonwealth level, but will not incur a penalty for engaging in the same activities in respect of state taxes.

Most tax practitioners are (or should be) aware of their obligations not to promote tax avoidance under the promoter penalty regime for Commonwealth taxes and therefore, arguably, it should not be difficult to extend this regime to state taxes.

It is suggested that a promoter penalty regime would also not be difficult to administer and could be policed as part of existing audits. Furthermore, because of information that is already collected by the Office of State Revenue in relation to the lodging party it should not be overly burdensome to identify whether a particular firm was involved in promoting a number of tax avoidance schemes.

2.4 Design of a Promoter Penalty Regime

Like the uniform GAAR, it is suggested that a state promoter penalty regime should be located in the WA TAA and apply to the promotion of tax avoidance in respect of all state taxes. It is suggested that the WA promoter penalty regime should be substantially based on the Commonwealth regime and therefore contain the following key elements: an objects clause, an operative provision prohibiting an entity being a promoter of a tax exploitation scheme and a rigorous and flexible penalty regime.

2.4.1 Objects Clause

Given the nature of a promoter penalty regime arguably, like a uniform GAAR, it should also contain an objects section. The primary objective of the Commonwealth promoter penalty regime is to deter the promotion of tax avoidance and evasion schemes. The secondary objective is to deter implementing a product ruling in a way that is materially different to that described in a product ruling.[90]

In this regard, the stated primary objective for a WA promoter penalty regime could be the aligned with the first stated objective in section 290-5 of the TAA 1953 (Cth), being to deter tax avoidance and evasion schemes. The second stated object of deterring implementation of a scheme in a way that is different to that described in a product ruling, would not be applicable in WA as product rulings are not offered for state taxes. Even though, WA offers pre-transaction decision requests in relation to the reconstruction exemptions in Chapter Six and the application of Chapter Seven, these are not intended to bind more than one individual and when the transaction is implemented an exemption must be obtained again at the time of transaction. Therefore, this secondary objective of the Commonwealth promoter penalty regime would not be relevant in the context of state tax.

2.4.2 Operative Provisions

It is suggested that the operative provisions of the WA promoter penalty regime could be substantially based on the Commonwealth promoter penalty regime by providing

[90] Section 290-5 of the TAA 1953.

that an entity must not engage in conduct that results in that or another entity becoming a promoter of a tax exploitation scheme. [91]

Likewise, if this operative provision was adopted, the WA promoter penalty regime should adopt the Commonwealth's definition of 'tax exploitation scheme', 'promoter' and 'scheme benefit'.

The term 'tax exploitation scheme' is defined in section 290-65 of the TAA 1953, to mean a scheme where at the time of promotion, it is reasonable to conclude that an entity entered into or carried out the scheme for the sole or dominant purpose of getting a scheme benefit and it is not reasonably arguable that the scheme benefit sought is, or would be available, at law.

A scheme can constitute a tax exploitation scheme whether or not it is implemented. Scheme benefit is defined in section 284-150(1) as an entity will get a scheme benefit if a tax related liability is, or could reasonably be expected to be, less than it would apart from the scheme. This definition is generic enough to be adopted for WA state tax purposes.

An entity is a promoter if it markets or otherwise encourages growth or interest in a scheme and the entity or associate directly or indirectly receives consideration in respect of the marketing or encouragement.[92] It is reasonable to conclude, having regard to all relevant matters, that the entity has a substantial role in respect of marketing or encouragement. [93] A person will not be a promoter if they merely provide advice about the scheme, even if the advice provides alternative ways to structure a transaction or sets out the risks of alternatives. [94]

These three definitions would also need to be adopted for a WA promoter penalty regime, to consolidate the operation of the operative provisions.

2.4.3 Penalty Provisions

In WA the penalties for promotion of a tax avoidance scheme, would need to be determined in conjunction with the current penalty tax provisions in Division 3 of the WA TAA. However, it is suggested that like the Commonwealth promoter penalty regime, the penalties for being a promoter should be broad and flexible, so that they can be altered or adapted to the severity of the conduct engaged in. In this regard the Commonwealth promoter penalty regime again provides a useful model.

2.5 Civil Penalty

The Commonwealth promoter penalty regime allows the Commissioner to request that the Federal Court impose a civil penalty on a scheme promoter/implementer.[95] An appropriate penalty would be fundamental to the success of the state promoter penalty regime, to ensure the provisions have a powerful deterrent effect.

[91] Section 290-50(2) of the TAA 1953 (Cth).
[92] Section 290-60 of the TAA 1953(Cth).
[93] Section 290-60(1) of the TAA 1953(Cth).
[94] Section 290-60(2) of the TAA 1953(Cth).
[95] Section 290-50(3) of the TAA 1953(Cth).

The maximum penalty is the greater of $550,000 for an individual (5000 penalty units) or 25,000 penalty units (2.75 million for a company) and twice the consideration received or receivable, directly or indirectly by the entity or its associates, in respect of the scheme.

In deciding what penalty is appropriate, the Federal Court can have regard to all matters it considers relevant. However, section 290-50(5) provides a list of matters it should have regard to including:

- the consideration directly or indirectly received (or receivable) by the entity and its associates;
- deterrent effect of the penalty;
- the amount of loss or damage incurred by scheme participants;
- period for which the conduct was extended; and
- deliberateness of the promoter's conduct.[96]

This type of discretion could be extended to the Supreme Court in the state tax context to ensure the regime provides penalties that appropriately reflect the severity, duration and recidivism of the conduct.

2.6 Injunction and Voluntary Undertaking

The WA promoter penalty regime should also include the ability to seek "real time remedies" such as injunctions to stop the promotion of tax avoidance schemes and the ability to seek a voluntary undertaking from the promoter not to engage in such conduct.

Other remedies available under the Commonwealth promoter penalty regime include an injunction to stop promotion of a scheme and the ability to enter into voluntary undertakings with promoters and implementers regarding the way schemes are promoted/implemented.[97]

Notably, if a uniform GAAR is adopted and administrative guidance is established on its operation, guidance should also be included on the administration of the state promoter penalty regime.

[96] Sections 290-50(4) and (5) of the TAA 1953(Cth).
[97] Subdivision 290-C of the TAA 1953(Cth).

3. PART THREE: CONCLUSION

Tax avoidance schemes constantly evolve and accordingly, strategies to combat tax avoidance must also remain dynamic and flexible. It is submitted that if WA's tax avoidance strategy involves the enactment of a uniform GAAR that embodies all of the strongest elements of the other state, territories and Commonwealth GAARs, in conjunction with the enactment of a promoter penalty regime, it will provide both a more effective tax avoidance strategy and act as a blue print for other tax administrators.

Whilst this article has been written in the WA context, as noted above and throughout the paper, the reform measures that have been recommended could be equally applied by other state and territory administrators.

The benefits of adopting a uniform GAAR across duty, payroll and land tax Acts could apply to any state or territory that does not already utilise a uniform GAAR such as Queensland, New South Wales and Victoria. This will enhance simplicity for taxpayers and their advisors and provide protection to the revenue base for all state taxes.

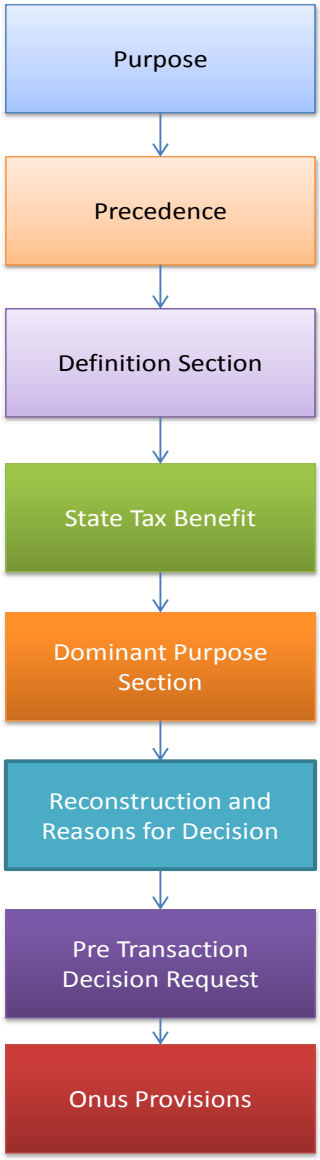
Likewise, the suggested key elements for drafting a uniform GAAR that draws upon the strengths of each of the state and territory GAARs would appear to be beneficial to any state or territory in protecting the integrity of the taxation base.

Apart from the Victorian Duties Act which contains limited provisions to prosecute promoters of tax avoidance schemes, none of the other states or territories have a promoter penalty regime. Therefore, the application of this recommendation could be applied by any of the other states or territories and a broader set of provisions could be enacted in Victoria. Adopting this type of regime by state and territory administrators could effectively accomplish the aims of:

- Deterring tax advisers in relation to the promotion of tax avoidance schemes;
- Creating equity in the treatment of taxpayers and advisers across all levels of taxation; and
- Promoting consistency with the Commonweallth regime and across states and territories.

Tax avoidance in Australia can represent a problem for state, territory and Commonwealth governments and therefore strategies to combat avoidance should also be informed, co-ordinated and developed in light of the work and lessons learnt by tax administrators at all levels.

APPENDIX 1: ESSENTIAL COMPONENTS OF A UNIFORM STATE TAXATION GAAR



Purpose

The purpose of the GAAR should be enunciated. This may include to deter tax avoidance schemes to reduce or defer liability to pay state tax. [98]

Precedence

It should be clarified that no provision of this Act or a state taxation law will limit the operation of the uniform GAAR.

Definition

The definition section needs to contain a definition of foreign tax, scheme and any other relevant terms.

The definition of "foreign tax" and "scheme" should be taken verbatim from 268(1) of the Duties Act. Foreign tax will therefore mean tax: 'duty or impost imposed under a law of the Commonwealth, another State or Territory or country other than Australia.'

The definition of "scheme" should also be taken verbatim from section 267(1) of the Duties Act. This will include: "the whole or any part of:

(a) a trust, contract, agreement, arrangement, understanding, promise or undertaking (including all steps and transactions by which it is carried into effect) –
   i. whether made or entered into orally or in writing; and
   ii. whether express or implied; and
   iii. whether or not it is, or is intended to be, enforceable;
   and
(b) a plan, proposal, action, course of action or course of conduct."

It should be further clarified that a reference in the GAAR applies in relation to a scheme if it is a unilateral scheme and includes a reference to the carrying out of a scheme by a person together with another person or persons.

State Tax Benefit

The concept of a duties benefit would need to be expanded in the context of a uniform GAAR. It could perhaps be rebadged as a state tax benefit. Arguably, a broad comprehensive definition like that currently contained in section 268 of the Duties Act should be maintained. A reference to a state tax benefit includes an elimination, reduction or postponement in the liability of a person for state tax (duty, pay-roll tax and land tax). It should also be clarified that when ascertaining a state tax benefit any purpose relating to foreign tax is disregarded.

[98] Most of the below sections are taken verbatim from Chapter Seven of the Duties Act but have been re-ordered and are refined.

Schemes to which Part applies

The GAAR should apply to any scheme that has been or is entered into, whether the scheme is entered into or carried out, in or outside WA, or partly in WA and partly outside WA; or whether a person that enters into or carries out the scheme is a person that is liable to pay pay-roll, land or duty.

Transitional provisions will need to be enacted to ensure that it only applies from the date of enactment of the uniform GAAR e.g. a scheme where at least one of the transactions by which it is carried into effect is post the date of enactment.

The dominant purpose test should be based on that contained in section 177D of the ITAA 1936 to state that it would be concluded that the relevant person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant person to obtain a state tax benefit. It is also suggested that the six factors currently contained in section 270(3) be enumerated as the factors the Commissioner should have regard to when determining dominant purpose. These factors (taken directly from section 270(3)) would include:

(i) the way in which the scheme was entered into or carried out;
(ii) the form and substance of the scheme including –
    a. the legal rights and obligations involved in the scheme; and
    b. the economic and commercial substance of the scheme
(iii) when the scheme was entered into and the length of the period during which the scheme was, or is to be, carried out;
(iv) any change to a person's financial position, or any other consequence, that has resulted, will result or may reasonably be expected to result from the scheme having been entered into or carried out;
(v) the nature of the connection, whether of a business, family or other nature, between the person that has entered into or carried out the scheme and any person mentioned in paragraph (d);
(vi) the circumstances surrounding the scheme.

Commissioner's determination

Where a state tax benefit has been obtained, or would but for the GAAR be obtained, by a person in connection with a scheme to which the GAAR applies, the Commissioner may determine the state tax which would have been payable or could reasonably have been expected to be payable by any person that entered into or carried out the scheme or any other person but for the scheme.

To give effect to the determination the Commissioner can make an assessment or reassessment.

Amendments that have been proposed in relation to the counterfactual in Part IVA would need to be monitored and incorporated as appropriate.

Reason for Decision

The assessment or re-assessment notice issued should be accompanied by the Commissioner's reasons for decision and ground on which the determination is made.

Pre-Transaction Decision Requests

Provisions should be inserted allowing the Commissioner to determine if a proposed scheme would be disregarded under the uniform GAAR.

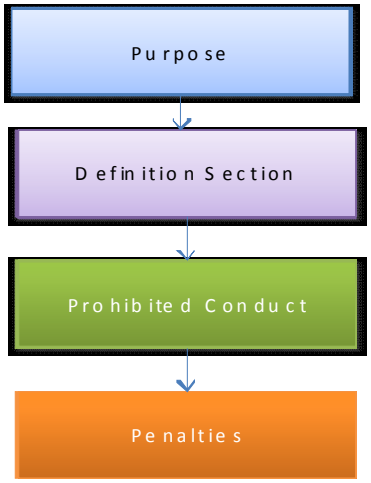
This could be based on sections 269(2) – (8) of the Duties Act, but it would need to be considered if this facility could be extended to pay-roll and land tax. It is unlikely that it would be as relevant to pay-roll tax and land tax and therefore it may just be specific to Duties. It should allow the Commissioner to seek such information as is necessary and to refuse to make a determination on similar grounds to a section 269(5) determination if:

- the scheme has been enacted into or carried out;
- the Commissioner has already made (or refused to make) a decision request in relation to a same or similar transaction or acquisition;
- a request for information is not satisfied.

Onus Provisions

The onus provisions should be reversed so that in relation to an appeal against the uniform GAAR, the onus should be with the taxpayer.

APPENDIX 2: WA PROMOTER PENALTY REGIME [99]



Purpose

The purpose of this Part should be stated to be to deter the promotion of tax avoidance schemes and tax evasion schemes.

[99] The structure of this section is based on the Commonwealth promoter penalty regime.

Definition Section

The definition section should include a definition of entity, promoter, tax exploitation scheme and state tax benefit.

These definitions of promoter and tax exploitation scheme should be adopted from the Commonwealth promoter penalty provisions.

Broadly, the term "tax exploitation scheme" would mean a scheme where at the time of promotion, it is reasonable to conclude that an entity entered into or carried out the scheme for the sole or dominant purpose of getting a scheme benefit and it is not reasonably arguable that the scheme benefit sought is, or would be available, at law.

A scheme can constitute a tax exploitation scheme whether or not it is implemented. Scheme benefit is defined in section 284-150(1) as an entity will get a scheme benefit if a tax related liability is, or could reasonably be expected to be, less than it would apart from the scheme. This definition is generic enough to be adopted for WA state tax purposes.

An entity is a promoter if it markets or otherwise encourages growth or interest in a scheme and the entity or associate directly or indirectly receives consideration in respect of the marketing or encouragement.[100] It is reasonable to conclude, having regard to all relevant matters, that the entity has a substantial role in respect of marketing or encouragement. [101] A person will not be a promoter if they merely provide advice about the scheme, even if the advice provides alternative ways to structure a transaction or sets out the risks of alternatives. [102]

Notably, it may be possible in this regard for the drafters of the promoter penalty regime in WA to "link" with modification to the Commonwealth penalty regime.

Prohibited Conduct

An entity must not engage in conduct that results in it or another entity being a promoter of a tax exploitation scheme.

Penalty Provisions

The penalty provisions should be as broad as possible including civil penalties, undertakings and injunctions. This would need to work in conjunction with the existing penalty provisions in the WA TAA.

[100] Section 290-60 of the TAA 1953 (Cth).
[101] Section 290-60(1) of the TAA 1953 (Cth).
[102] Section 290-60(2) of the TAA 1953 (Cth).

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An ordered approach to the tax rules for problem solving in a first Australian income taxation law course can improve student performance

Dale Boccabella*

Abstract

The core tax legislation that students are expected to understand in a first-time Australian income tax course (and tax legislation that early career tax practitioners are expected to understand) suffers from a number of deficiencies or challenges including overlap in assessable income provisions, overlap in deduction (or cost recognition) provisions, a shortage of express ordering rules and the presence of regime co-ordination rules that are "hidden". It is little wonder students find income taxation law difficult. However, in spite of deficiencies in the legislation, Australia's core tax rules do have a conceptual structure and considerable coherence, even if not immediately apparent. An approach to the tax rules that takes account of this structure and coherence is much more likely to lead to better problem solving. The ordered approach in this paper does this. The approach first centres on the conceptual structures in the general provisions, and secondly, if necessary, the "remedial" provisions that address a "failure" of part of the conceptual structure. This article sets out the ordered approach to problem solving. Importantly, the article makes the argument for this approach, partly by reference to the types of errors that can be made where the ordered approach is not adopted.

1. INTRODUCTION

This article makes a contribution to improving the quality of tax problem solving skills of students studying an Australian income tax course for the first time. The approach should also assist tax practitioners in the earlier part of their careers. It does this by suggesting a particular order of application of the tax rules to a transaction. An ordered or structured approach is needed because the core tax legislation students are expected to understand suffers from a number of deficiencies including overlap in assessable income provisions, overlap in deduction or cost recognition provisions, a general lack of express ordering rules and the presence of regime co-ordination rules that are "hidden".[1]

* Associate Professor, School of Taxation and Business Law, Australian School of Business, The University of New South Wales.

[1] The deficiencies or challenges of the income tax are briefly explained in P Burgess, G S Cooper, R E Krever, M Stewart and R J Vann, *Cooper, Krever & Vann's Income Taxation: Commentary and Materials*, 6th ed., Thomson Reuters, Pyrmont, 2009 at paragraphs 2.360-2.470.

In spite of the deficiencies in the legislation, Australia's core tax rules do have a conceptual structure and considerable coherence even if not immediately apparent. It is submitted that student understanding of this structure and coherence and better problem solving is more likely to be achieved if the author's approach to problem solving is adopted.[2] Briefly stated, the approach centres on the conceptual structures in the general provisions, and from there, the focus turns to "remedial" provisions that address a "failure" of the conceptual structure.

The article argues that students should adopt the suggested ordering in their tax problem solving, as this is the best way of ensuring comprehensiveness and accuracy in the solution. It is also suggested that the suggested ordering better reflects legislative intent (or the correct interpretation of the legislation). Further, through promotion of comprehensiveness that facilitates awareness of relationships between rules, the suggested approach should make a contribution towards the promotion of "deeper learning". The author concedes that following a "disordered approach"[3] does not necessarily lead to errors in problem solving as the problem solver may get to the correct outcome in any event.[4] It is submitted though that the author's ordered approach to the tax rules gives a much higher chance of better problem solving compared to a disordered approach.[5]

Aside from this introduction and the conclusion, the article is in three parts. Part 2 sets out the broad structure or fundamental structure of most of the tax rules studied in a first income tax course. This outline is divided into Receipts, Profits, Gains or Benefits, which activates assessable income or charging provisions (Sub-Part 2.1), and Expenses, Outgoings or Losses, which activates expense conferral provisions (Sub-Part 2.2). Part 3 provides examples of a number of errors that first-time tax students have made in tax problem solving in assignments, tutorial problems, exams, etc, as observed by the author over a considerable period. Some of these "errors" do not necessarily lead to a substantively incorrect answer, although incorrect as a matter of tax law.

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[2] It is possible that first time tax students, on the advice of their tax lecturers, may be using a particular approach. Further, in P Burgess, G S Cooper, R E Krever, M Stewart and R J Vann, *Cooper, Krever & Vann's Income Taxation: Commentary and Materials*, 6th ed., Thomson Reuters, Pyrmont, 2009 at paragraphs 2.380-2.460, the authors have set out a series of questions or issues that should be considered when approaching a tax problem. While this is helpful to the problem solver, this outline does not (and perhaps cannot, given the space constraints): (i) expressly set out an ordered approach to the tax rules (ii) provide reasons as to why an ordered approach to the tax rules maximises the chances of better problem solving and (iii) indicate errors that can be made from using a disordered approach.

[3] A "disordered approach" is any approach that is quite different to the one suggested in this article.

[4] The author recalls his early study of taxation law where making mistakes served as a very good learning opportunity. In a way, having someone else suggest an effective approach to tax problem solving denies the learner the learning opportunities that come from making mistakes.

[5] The fact the judiciary, when deciding a tax dispute, does not follow the ordered approach set out in this article or any other comprehensive approach is not a reason for students not following the ordered approach. The issue(s) that a tax judge needs to resolve in making their decision is often narrowed down for them by the parties (ATO and taxpayer), mainly because the parties have agreed on the application or otherwise of other relevant provisions.

Part 4 sets out the suggested ordering approach to tax rules in the core areas of study for first time students. Part 4 also explains why the ordered approach is a superior approach to the application of tax rules. At times, this discussion is cross-referenced to the errors in Part 3. The conclusion of the article is that the ordered approach is very likely to lead to better tax problem solving and a deeper understanding of the tax rules.

2. BROAD STRUCTURE AND MAIN FEATURES OF INCOME TAX RULES STUDIED IN FIRST INCOME TAX COURSE[6]

The appendix to this paper gives a brief outline of the topic areas taught in the first income tax course run by the author for students in the Master of Professional Accounting degree at his university. It will be apparent that the central aim of such a course is to assist students determine a taxpayer's liability to the Australian Taxation Office. A major element in calculating taxpayers' liability is their taxable income for an income year.[7] In turn, taxable income equals assessable income less deductions.[8] A tax loss will usually be the excess of deductions over assessable income.[9] It is these two components of taxable income, one generally concerned with receipts and the other expenses, that a first income tax course is primarily concerned with.

2.1 Receipts, Profits, Gains or Benefits

The broad overall aim when dealing with a receipt or profit is to determine whether the legislature intended that the receipt, or part of the receipt, enter the tax base (usually assessable income directly) of the taxpayer. In many situations, this is very likely to require examination of more than one tax rule or more than one provision in the income tax legislation. An appreciation of the character or the role of tax rules will assist in this endeavor.

2.1.1 Ordinary Income Provision (s 6-5)

The ordinary income provision (s 6-5) is the most significant charging provision within the income tax legislation in terms of amounts included in assessable income.[10] It is only a receipt or profit that is "income" that can come within s 6-5. For a particular receipt or profit to be income, it must satisfy certain "positive criteria", and avoid satisfying (fall outside) certain "negative criteria". The criteria are all judge-made law. The positive criteria are referred to here as the five "well recognised" sources or categories of income.[11] They are: (1) Proceeds of personal exertion (2)

[6] It needs to be stressed that where this outline purports to state the tax rules, the outline is limited and is general in nature. That is all that is required for the purpose of this article. If the reader wishes to obtain a deeper understanding of the relevant tax principles, reference must be made to the legislation, cases and commentary in textbooks.

[7] Subsection 4-10(2) of the *Income Tax Assessment Act* 1997. All references to sections containing a dash (-) are references to the ITAA 1997, unless stated otherwise.

[8] Subsection 4-15(1).

[9] I say generally because where a taxpayer has "net exempt income" for an income year, the tax loss is also reduced by net exempt income: s 36-10(3).

[10] It is also likely that the income section (now s 6-5, and before that, s 25(1) of the ITAA 1936) is the second-most litigated provision in the income tax law. The general deduction section (now s 8-1, and before that, s 51(1) of the ITAA 1936) is likely to be the most litigated.

[11] It needs to be noted that the income categories are not as neat as suggested above: see discussion of the majority in the High Court in *FCT v Montgomery* 99 ATC 4749 at 4760-4762.

Proceeds of business (3) Return from property (4) Compensation receipts principle (compensation for lost income or lost revenue asset) and (5) Factorial approach to characterisation (i.e. taking account of all the facts, the amount is income).[12] The negative criteria refer to the presence of a fact or circumstance that denies the receipt being income. The presence of just one negative criterion in regard to a positive criterion (category) is enough to prevent an amount being income under that category.[13]

At the risk of over-simplification, and even inaccuracy, the following table attempts to capture the most relevant criteria (principles):

POSITIVE CRITERIA	NEGATIVE CRITERIA
Proceeds of Personal Exertion: The receipt, gain or benefit is a product of the taxpayer's personal exertion	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right; or (f) The benefit, being a non-cash benefit, cannot be converted into money.
Proceeds of Business: The receipt, gain or benefit is a product of the taxpayer's business. This should also cover the so-called isolated business venture (or isolated profit-making venture)	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right "of the business"; or (f) The benefit, being a non-cash benefit, cannot be converted into money.
Return from Property: The receipt, gain or benefit is a return from putting one's property to work	(a) The receipt is a benevolent rental or a contribution to costs; or (b) The receipt is for the sale or realisation of the property, or part of the property; or (c) The receipt is for the grant of a lease over the property (instead of for use of the property); or (d) The benefit, being a non-cash benefit, cannot be converted into money.

[12]The author came across the term "Application of the 'factorial' approach" in R H Woellner, T J Vella, L Burns and S Barkoczy, *1996 Australian Taxation Law*, 6th., CCH, North Ryde, 1996 at paragraph 6.160. The most recent application of the factorial approach to income characterisation seems to be the High Court decision in *FCT v Anstis* 2010 ATC 20-221 at 11,651-11,653 in regard to government youth allowance payments to a university student.

[13]The negative criteria can also be viewed as a failure to satisfy a relevant positive criterion.

Compensation Receipts Principle: The receipt is compensation for lost income or compensation for a lost revenue asset	(a) The compensation is for a lost receipt that would have been capital; or (b) The compensation is for a lost structural asset (capital asset); or (c) The compensation is for damage to, or destruction of a, structural asset; or (d) The compensation is for the loss or destruction of a private asset.
Factorial Approach to Characterisation as Income: On consideration of all the facts surrounding the receipt, it is income	(a) The receipt is received on personal grounds; or (b) Receipt is an instalment of the sale proceeds for an asset.

Aside from the positive criteria and the negative criteria, the income concept is not limited to designated types of receipts or profits, or particular subject matter. And, there is no express ordering rule. That is, there is no guidance advising the problem solver that the ordinary income section must be applied before a specific assessable income section (see below), or the other way around. This issue is addressed under the following topic (Sub-Part 2.1.2).

2.1.2 Specific Assessable Income Provisions, Aside from the Capital Gains Tax Regime and Fringe Benefits Tax Regime

The legislature does not intend s 6-5 to be the only assessable income provision. The legislature wants taxpayers to be taxed on more than just income receipts or income profits for whatever reason.[14] Some examples of provisions (sections) that include amounts in assessable income where s 6-5 may not otherwise apply are: s 15-2 (value of benefits in respect of employment or services rendered), s 15-10 (bounty or subsidy received in relation to carrying on business) and s 15-25 (receipt of payment from former lessee for failing to make repairs to premises). In this sense, the legislature is "correcting" for the deficiency of, or the limitations of, the income concept as developed by the judiciary. As a matter of logic, these assessable income provisions would not be required if the income concept was "broad enough" to capture the receipts dealt with in these provisions.[15]

As expected, these specific assessable income provisions usually deal with a particular category of receipts or profits and/or circumstances (e.g. benefits in regard to employment or services rendered: s 15-2, bounty or subsidy in relation to a business: s 15-10). Each specific assessable income section will be correcting for a deficiency (or more than one deficiency) with the income concept; they will not all be correcting for the same deficiency although the "capital" deficiency would feature prominently. That is, the specific assessable income section may be required because the receipt involved is likely to be capital under general principles in s 6-5. Sections 15-10 and 15-65 (grant for leaving sugar industry) appear to be examples of correcting for the capital

[14]The equity (or fairness) criterion provides an explanation for the existence of many specific assessable income provisions.

[15]These specific assessable income provisions have been given the label "statutory income" by the legislature: ss 6-10 and 6-15.

conclusion. Section 15-2 corrects to overcome the non-convertibility doctrine for non-cash benefits.[16] While s 15-25 may be correcting for the capital conclusion, it may also be correcting for the difficulty of linking the receipt to the former lessee's use of the premises. Subsection 20-35(1) (recoupment of expenses for which certain deductions were obtained) may be correcting for the failure of the judiciary to adopt a general reimbursement principle.[17] Subsection 40-285(1) (recoupment of previous depreciation deductions on sale of depreciating asset) is correcting for the fact that tax depreciation (deductions) was faster than economic depreciation. But, s 40-285(1) also corrects for the capital conclusion in regard to the sale proceeds above original cost of the asset.

It should be noted that not one specific assessable income section studied in a first income tax course expressly requires the receipt or profit to be capital in nature in order for the specific assessable section to apply.

Some specific assessable income sections do not appear to have any real role because the receipts dealt with in those sections are very likely to be income in any event. Section 15-15 (profit from profit-making undertaking), s 15-20 (ordinary royalty), s 15-30 (insurance or indemnity for lost amount that would have been assessable income), s 15-50 (work in progress receipt) and s 70-115 (insurance or indemnity for lost trading stock) are likely to be in this category.[18]

At least once where the legislature has corrected for a deficiency in the income concept that correction is not by way of a specific assessable income section. The example is s 21A of the *Income Tax Assessment Act* 1936. This section does not include an amount in assessable income. Rather, the main thing s 21A does is to overcome (displace) the non-convertibility doctrine in regard to non-cash benefits obtained by a business taxpayer.[19] That means that the requirements of s 6-5 (or requirements of any other specific assessable income section) still need to be satisfied in order for the value of the non-cash benefit to be included in assessable income.

There is no express ordering rule. That is, there is no express guidance advising the problem solver that the ordinary income section must be applied before a specific assessable income section, or the other way around. However, many specific assessable income provisions co-ordinate with s 6-5 so that if s 6-5 applies to include the receipt in assessable income, the specific provision will not include the receipt in assessable income (e.g. ss 15-2, 15-10, 15-25). The presence of these express co-

[16]A non-cash benefit that cannot be converted into money is not income: *FCT v Cooke and Sherden* 80 ATC 4140 at 4149. In light of the decision in *Smith v FCT* 87 ATC 4883, and in particular, the judgment of Brennan J at 87 ATC 4888, a strong case can be made that employment (s 15-2) is a broader concept than an income-producing activity (s 6-5), and that therefore s 15-2 has a broader operation than s 6-5.

[17]A general reimbursement principle could involve a rule such that, where a taxpayer obtains a reimbursement or recoupment of an expense that was deductible under the general deduction section, then the reimbursement would be income: *FCT v Rowe* 97 ATC 4317 at 4319. The existence of such a principle was rejected some 45-years ago in *H R Sinclair Pty Ltd v FCT* (1966) 14 ATD 194 at 195 (per Taylor J) and at 196 (per Owen J). And, more recently, the principle was also rejected in *FCT v Rowe* 97 ATC 4317 at 4321 and at 4329.

[18]Given the case law on the predecessor provisions to ss 15-15 (s 25A), 15-30 (s 26(j)) and 70-115 (s 26(j)), it is hard if not impossible to see why the transactions covered by those provisions is not income.

[19]Section 21A also seems to provide a valuation rule for all non-cash business benefits (i.e. whether or not the benefit is in fact convertible into money): see introductory words in s 21A(2).

ordination rules makes it hard to suggest that any of the specific assessable income sections exclude s 6-5 from operating. In one sense, these co-ordination rules are ordering rules (i.e. apply s 6-5 first). The co-ordination rules in the specific assessable income provisions can also be seen as anti-double taxation measures.[20] It is important to remember that it is a condition of these specific assessable income sections that the receipt not be income. There is also an obscure co-ordination rule on the sale of a depreciating asset so that if the sale proceeds above original cost is income, that part of the sale proceeds are not counted for the purpose of calculating the assessable income inclusion on the sale under the depreciating asset regime.[21] This can be seen as both an ordering rule and an anti-double taxation rule.

Other specific assessable income sections do not co-ordinate with s 6-5 (e.g. ss 15-3, 15-50 and s 44 of the ITAA 1936). There is no basis for the implication that these specific assessable income sections exclude s 6-5 from applying to the transactions falling under them.[22] These sections do not therefore provide an, in effect, ordering rule and nor do they expressly prevent double taxation. In these circumstances, s 6-25 may have to provide the "co-ordination" or ordering rule and also the anti-double taxation rule. Section 6-25 gives priority of operation to the specific assessable income section (over s 6-5), unless a contrary intention appears.[23] It is worth pointing out here that s 6-25 does not apply where a receipt or profit gives rise to income and also a capital gain under the CGT regime. The co-ordination rules in such circumstances are contained within the CGT regime (see Sub-Part 2.1.4 below).

2.1.3 Exempting Provisions, outside of the CGT Regime[24]

The main point of exempting provisions is that the legislature has decided that certain categories of receipts should not enter taxpayers' tax base (i.e. not be taxed). Some of these provisions overcome what would otherwise have been an inclusion under the income concept (s 6-5).[25] A much smaller number of these provisions overcome what

[20]Preventing double taxation on the one amount need not be achieved within one of the two sections that would otherwise include the amount in assessable income. Having a general anti-double taxation rule in a stand-alone section should work just as effectively. Indeed, s 6-25 uses this approach: see below.

[21]Subsection 40-300(3).

[22]See the analysis in the majority judgment in the High Court case of *FCT v McNeil* 2007 ATC 4223 at 4230-4232 where the majority rejected an exclusive code argument in regard to s 44 of the ITAA 1936. The exclusive code argument would generally have meant that s 6-5 was excluded from applying to receipts that accrued to shareholders in companies because s 44 would have dealt with these exclusively.

[23]Section 6-25 probably operates in a similar manner to the rule of statutory interpretation that gives priority of application to a specific provision over a general provision where both could apply: see D C Pearce and R S Geddes, *Statutory Interpretation in Australia*, 7th ed., LexisNexis Butterworths, Sydney, 2011 at paragraphs 4.38-4.40 for a discussion of this principle.

[24]These types of provisions receive little attention in the Taxation Law course taught by the author.

[25]Sections 51-1 and 51-5 make pay and allowances received by members of the Naval, Army or Air Force Reserve exempt income. In absence of these sections, these amounts would be included in assessable income under s 6-5. Section 51-57 makes post-judgment interest on a damages award for personal injury exempt income. In the absence of s 51-57, the post-judgment interest would be included in assessable income under s 6-5: *Whitaker v FCT* 98 ATC 4285.

could otherwise have been an inclusion under a specific assessable income section.[26] As expected, these exempting provisions deal with particular categories of receipts or profits and/or circumstances. In a sense, each specific exemption provision is correcting for the "overreach" of the assessable income provision that would otherwise apply.

Sometimes, an exempting provision seems to be in the legislation merely to make absolutely certain that a particular receipt is not to be treated as assessable income (i.e. exempting provision probably not required).[27]

2.1.4 CGT Capital Gains Tax (CGT)

The capital gains tax regime is a significant regime within the income tax in terms of inclusions in assessable income.[28] The CGT regime can include an amount in taxpayers' assessable income if the taxpayer has a "net capital gain".[29] It is important to note that an assessable income inclusion is the only outcome that can arise from the CGT regime for a taxpayer for an income year. The reason for this is that "net capital losses" - the opposite of net capital gains - are quarantined [within the CGT regime] for use only against future net capital gains (i.e. net capital losses are not a deduction).[30]

It is important to note that the amount that enters a taxpayer's assessable income under the CGT regime can be the "netting off" of capital gains and capital losses from a number of transactions (CGT events), and not just one transaction. In this regard, the CGT regime is quite different to "other assessable income provisions" mentioned above (Sub-Part 2.1.2). In spite of this, the CGT regime should still be seen as a transaction tax. Indeed, the CGT regime contains numerous rules that designate which capital gains are chargeable gains and which are not, and which capital losses obtain loss recognition and which do not. Some of these rules are designed to prevent double taxation because the receipt or profit on the transaction may already be taxed under the non-CGT regime (e.g. s 6-5).

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[26]Section 59-50 (clean-up and restoration grants for small businesses in regard to the 2009 Victorian bushfires) may be an example of this. These receipts may be included in assessable income under s 15-10, in the absence of s 59-50.

[27]The exempt income provision dealing with maintenance receipts (s 51-30, along with s 51-50) is probably in this category because such receipts may be regarded as mere gifts given on personal grounds. Section 17-5, which excludes GST on a taxable supply under the GST regime from being included in assessable income, may also provide an example. According to the ATO's analysis in Class Ruling CR 2002/83, s 51-60 is also likely to be in this category (Prime Minister's prizes for Australian History, Science, etc). One concern with some of these "exempting provisions", a minor one, is that if an amount is exempt income, the amount of net exempt income reduces the taxpayer's tax loss for the income year (s 36-10(3)). The strong implication is that the exempting provision is excluding from assessable income something that is income on ordinary principles. If the receipt is not income in the first place, then it may be that the receipt cannot be exempt income and therefore does not have to be counted to reduce a tax loss. It is arguable that the maintenance payments are in this category; they may not be income in the first place, and yet they are declared to be "exempt from income tax" by s 51-30 along with s 51-50.

[28]The CGT regime covers Divisions 100-152 of the ITAA 1997. It will be appreciated that the CGT regime is not a separate, stand-alone tax.

[29]Subsection 102-5(1).

[30]Section 102-10 and s 102-15.

For a taxpayer to have a capital gain (or a capital loss), a "CGT event" must have occurred.[31] In a first income tax course, only a small number of CGT events will be studied.[32] Most of the CGT events studied involve the sale of, or the cessation of, a pre-existing asset. The formula for a gain is: "capital proceeds" minus "cost base".[33] The formula for a loss is: "reduced cost base" minus "capital proceeds".[34] Some of the CGT events studied involve transactions that do not involve the sale of a pre-existing asset.[35] Given that a particular transaction could fit within more than one CGT event, the CGT regime contains, amongst other things, some ordering rules (i.e. problem-solver must apply or analyse the CGT events in a particular order to the exclusion of some specified CGT events).[36] In addition, if a particular transaction is caught by more than one CGT event and the ordering rule does not preclude double counting, there is a rule stating that the most specific CGT event will apply.[37]

In regard to chargeable gains, the CGT regime can be seen as correcting for deficiencies in the income concept. The CGT regime mainly corrects for the "deficiency" that the income concept does not cover a capital receipt/capital profit.[38] This is the overwhelming purpose of the CGT regime. At times though, the CGT regime can also correct for the fact that the income concept does not encompass gains from a hobby, pastime, recreation or a non-business activity or private activity. Gains from the sale of some collectables and some personal-use assets are examples of this.[39]

It should be noted that the CGT regime is not limited to transactions on capital account. The term "capital proceeds" does not import the requirement that the transaction must be on capital account.[40] Nor do the terms "capital gain" or "capital loss". Accordingly, the CGT regime may also apply to transactions on revenue account. However, there is no express ordering rule in regard to a CGT event within the CGT regime and non-CGT assessable income sections (e.g. s 6-5). That is, there is no express guidance advising the problem solver that the ordinary income section or specific assessable income sections (aside from CGT regime) must be applied before applying a CGT rule, or the other way around. However, many rules in the CGT regime state that the CGT regime does not apply (more accurately, the capital gain or

[31]Section 102-20.
[32]The author's course only focuses on CGT events A1, C1, C2, D1 and F1.
[33]See for example, ss 104-10(4) and 104-25(3).
[34]See for example, ss 104-10(4) and 104-25(3).
[35]CGT event D1 (s 104-35) and CGT event F1 (s 104-110) would fall into this category.
[36]Subsection 102-25(1) and s 102-25(3).
[37]Subsection 102-25(1). The rule in s 102-25(1) probably operates in a similar manner to the rule of statutory interpretation that gives priority of application to a specific provision over a general provision where both could apply: see D C Pearce and R S Geddes, *Statutory Interpretation in Australia*, 7th ed., LexisNexis Butterworths, Sydney, 2011 at paragraphs 4.38-4.40 for a discussion of this principle.
[38]Just because a receipt is "capital" under s 6-5 does not mean it is caught as a capital gain under the CGT regime. To be a capital gain, the receipt or profit must give rise to a capital gain under a CGT event.
[39]Gains and losses on collectables are only recognised by the CGT regime if the acquisition cost of the collectable was more than $500: s 118-10(1). Gains are only recognised on personal use assets if the purchase cost was more than $10,000: s 118-10(3). In a lack of symmetry, losses are never recognised on personal use assets: s 108-20(1).
[40]The term capital proceeds merely describe one element in the calculation of a capital gain or capital loss.

capital loss is disregarded) where a non-CGT rule would apply to the transaction.[41] In one sense, these are ordering rules. These features of the CGT regime can also be seen as anti-double taxation measures. Another important rule within the CGT regime, and one that differs from the gain or loss disregard rules, is directed at preventing double taxation, namely, s 118-20. Where a transaction gives rise to both a non-CGT assessable income amount and a capital gain under the CGT regime, s 118-20 reduces the capital gain by the non-CGT assessable income amount. Again, in one sense, s 118-20 is also an ordering rule.[42]

2.1.5 Fringe Benefits Tax (FBT)

There is a category of benefits and receipts from employment that are taxed under a separate piece of legislation, namely, the *Fringe Benefits Tax Assessment Act* 1986 (FBTAA). Somewhat unusual under an "income tax", the taxpayer is the employer (who will usually be the provider of the benefit), and not the employee who receives the benefit.[43]

Again, the FBT regime can be viewed, in part, as correcting for deficiencies in the income concept (s 6-5). Arguably, the main deficiency would be the non-convertibility doctrine under the income concept.[44] However, the FBT regime can also be viewed as overcoming the valuation difficulties under the income concept for non-cash benefits, and the valuation difficulties under s 15-2 for non-cash benefits.[45] The FBT regime contains, for the most part, objective valuation rules that are designed to cater for particular benefits.

The key requirement for the FBT regime to apply to a benefit is that the definition of "fringe benefit" in s 136(1) of the FBTAA is satisfied. There is no express ordering rule. That is, there is no guidance advising the problem solver that the definition of a fringe benefit must be applied before applying the ordinary income rule or s 15-2 to the recipient of the benefit, or the other way around. There is a rule excluding a benefit from an employee's assessable income where the benefit is a fringe benefit under the FBTAA.[46] This can be seen as an anti-double taxation rule.

[41]For example, see s 118-24 (disposal of Division 40 depreciating asset), and s 118-25 (disposal of trading stock).

[42]The most obvious situation where s 118-20 would apply to prevent double taxation would be the sale of a revenue asset that is not trading stock.

[43]Subsection 66(1) of the FBTAA, and ss 5 and 6 of the *Fringe Benefits Tax Act* 1986.

[44]There is no express rule overcoming the non-convertibility doctrine in the FBTAA but, if required, s 148(1)(g) of the FBTAA would probably achieve this (irrelevant whether or not the benefit is in the nature or income).

[45]See for example *Case T76* 86 ATC 1076 at 1089 and the cases cited therein. See also Australian Government, *Reform of the Australian Tax System: Draft White Paper*, AGPS, June 1985 at paragraphs 8.1-8.21 for a discussion of the valuation problems and the various solutions available.

[46]Subsection 23L(1) of the ITAA 1936. It is also worth noting that if a benefit is an "exempt benefit" under the FBTAA, the benefit will also be excluded from the recipient's assessable income: s 23L(1A) of the ITAA 1936. This rule can be seen as preserving the FBT exemption in the hands of the recipient.

2.2 Expenses, Outgoings or Losses

The broad overall aim when dealing with expenses is to determine whether the legislature intended that the expense is to reduce the taxpayers' tax base, either through a deduction or through recognition under the CGT regime.[47] In most situations, this is very likely to require examination of more than one tax rule or more than one provision in the income tax legislation. An appreciation of the character or function of tax rules will assist the problem solver.

2.2.1 General Deduction Provision (s 8-1)

The general deduction provision (s 8-1) is the most significant expense recognition provision in the income tax legislation in terms of providing for reductions in the tax base.[48] For a particular expense, outgoing or loss to be deductible under s 8-1, the expense must satisfy one of the "positive criteria", and avoid satisfying (fall outside) the "negative criteria". It is important to note that the positive criteria and negative criteria here is not to be confused with references in the tax literature to the positive limbs and negative limbs under the general deduction section.[49]

Again, at risk of over-simplification, the following table attempts to capture the most common situations or relevant criteria:

POSITIVE CRITERIA	NEGATIVE CRITERIA
(a) **If Taxpayer's Activity is one of obtaining proceeds from Personal Exertion**: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity; or (b) **If Taxpayer's Activity is one of obtaining proceeds from Business**: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity; or (c) **If Taxpayer's Activity is one of obtaining returns from Property**: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity	(a) The expense, outgoing or loss is too remote from the taxpayer's income activity or proposed activity, or it is not a cost of carrying on the activity; or (b) The expense, outgoing or loss is too remote from the taxpayer's income activity or former activity, or it is not a cost arising from the activity; or (c) The expense is only partly incurred for producing assessable income (only part of expense is for taxable purpose); or (d) The expense is private; or (e) The expense is domestic; or (f) The expense is capital; or (g) The expense is related to producing exempt income.

[47] We are not concerned with expenses that provide a tax offset, and in any event, there are very few of these and most likely, none are dealt with in a first income tax course.

[48] The general deduction section is likely to be the most litigated provision in the income tax legislation.

[49] Section 8-1 is usually regarded as containing two positive limbs and three (or four) negative limbs. To obtain a deduction under s 8-1, the expense must satisfy one of the positive limbs and avoid all of the negative limbs.

The positive criterion refers to the idea that the expense must be sufficiently related to the taxpayer's assessable income activity in order that this criterion is satisfied. The negative criteria refer to the presence of a fact or circumstance that denies the expense being deductible under the general deduction section. The presence of just one negative criterion is enough to prevent an amount being deductible under s 8-1. (Most of the listed negative criteria can also be viewed as a failure to satisfy the positive criterion).

Aside from the positive criterion and the negative criteria, the general deduction section is not limited to designated types of expenses, outgoings, losses or particular subject-matter. And, there is no express ordering rule. That is, there is no guidance advising the problem solver that the general deduction section must be applied before a specific deduction section or a CGT asset cost base inclusion section, or the other way around. This issue is addressed under the following topic (Sub-Part 2.2.2).

2.2.2 Deduction Conferral Provisions, Loss Conferral Provisions, Etc, aside from General Deduction Section and Aside from CGT Regime

The legislature does not want s 8-1 to be the only deduction or loss recognition provision. The legislature wants taxpayers to obtain deductions on more than just expenses that satisfy s 8-1, for whatever reason. Some examples of sections that provide deductions or loss recognition where s 8-1 might or would not otherwise apply are: s 25-5 (broadly, tax compliance costs) and s 25-25 (borrowing expenses). These are referred to here as specific deduction sections.

The presence of specific deduction sections means the legislature is "correcting" for the deficiency of, or the limitations of, the general deduction section as set out in the section and as identified by the judiciary. Specific deduction sections would not be required if the general deduction section was "broad enough" to capture the expenses dealt with in these specific deduction sections.[50] Each specific deduction section will be correcting for a deficiency (or more than one deficiency) with the general deduction section; they will not all be correcting for the same deficiency although the capital deficiency will feature prominently. That is, the specific deduction section is required because the expense involved is likely to be capital under the general deduction section. However, there are times where the relevance or contemporaneity (too remote) deficiencies are corrected through a specific deduction section.[51] There are also times where the correction is made because the expenditure does not satisfy the criterion of being sufficiently relevant to producing assessable income.[52] And, there are times where the correction is for private expenditure.[53] Finally, there is no basis for the implication that any of the specific deduction sections excludes s 8-1 from the applying to the transactions dealt with within them.

[50]These specific deduction conferral provisions have been given the label "specific deductions" by the legislature: s 8-5(3).

[51]Section 25-50 (pension or gratuity payment to former employee), s 25-55 (payments to associations), ss 25-60 and 25-65 (contesting elections to a parliament or local government).

[52]Section 25-5 (tax compliance costs) and s 25-75 (rates and land tax related to producing mutual receipts).

[53]Section 30-15 (gifts or donations to deductible gift recipients).

As expected, most specific deduction conferral sections usually deal with a particular category of expense, outgoing or loss and/or circumstances (e.g. tax related expenses: 25-5, borrowing expenses: s 25-25, purchase of depreciating asset: s 40-25). There are also times where the specific deduction provision will only apply to a taxpayer carrying on a particular activity (e.g. s 40-880: business related costs).

The most significant specific deduction conferral sections are the capital allowance, depreciation or amortisation provisions. The main ones are: s 40-25 (depreciating assets), s 40-832 (listed capital project amounts), s 40-880 (business related capital costs) and s 43-10 (capital works). Three features of these provisions are worth pointing out here. First, they only apply if the expenditure relates to the production of assessable income (i.e. taxable purpose). Secondly, they only apply if the expenditure is of a capital nature. The capital requirement in at least some of these capital allowance regimes is not immediately apparent (i.e. hard to see), or at least it is not at the "front of the provisions".[54] Thirdly, they all contemplate apportionment of expenditure between the taxable purpose component and the non-taxable purpose component(s).

Some specific deduction conferral provisions do not seem to be required because s 8-1 would seem to confer the necessary deduction in any event. Section 25-10 (repairs), s 25-35 (bad debts) and s 25-40 (loss from profit making plan) may be examples of this. Perhaps having the specific deduction section provides a higher degree of certainty than s 8-1. Some deduction conferral sections or regimes contain internal exceptions, which can give the impression that there is a deduction denial role for the section.[55]

There is no express ordering rule. That is, there is no express guidance advising the problem solver that the general deduction section must be applied before a specific deduction conferral section, or the other way around. While very few specific deduction conferral sections co-ordinate with s 8-1, the specific deduction sections that involve capital allowances, depreciation or amortisation do implicitly co-ordinate with s 8-1 because those regimes can only apply if the expenditure is capital.[56] Given that the positive criteria within each capital allowance regime is broadly stated so that a given expenditure can fit within more than one regime (i.e. overlap), there are ordering rules and co-ordination rules between regimes to indicate the regime that takes priority. For example, s 43-10 takes priority over s 40-25 where both regimes would otherwise apply to expenditure.[57] Section 40-832 takes priority over s 40-880

[54]The capital requirement in the depreciating asset regime is contained in s 40-220, which is amongst the cost base inclusion provisions. The capital requirement in the capital works regime is contained in s 43-70(1), which deals with the definition of "construction expenditure".

[55]Section 25-100 is an example of this, and in particular, s 25-100(3).

[56]If expenditure is capital, s 8-1 cannot apply. If the expenditure is revenue, the capital allowance regimes cannot apply.

[57]Subsection 40-45(2).

where both regimes would otherwise apply to expenditure.[58] Indeed, subject to CGT cost base or CGT cost recognition,[59] s 40-880 is usually last in order of application.[60]

Finally, where an expense satisfies more than one deduction section (i.e. double deduction), s 8-10 provides an express rule to prevent this by requiring the deduction to only be deducible under the most appropriate provision.[61]

2.2.3 Deduction Denial or Loss Disregard Provisions

This category of provisions (or regimes) denies deductions or loss recognition for certain types of expenditures. The implication is that aside from the deduction denial provision, the designated category of expenditure would be deductible or receive loss recognition. And, that recognition would normally occur through the general deduction section.[62] Accordingly, deduction denial provisions can be seen as correcting for the broadness (overreach) of the general deduction section, as interpreted by the judiciary. Some examples of deduction denial provisions are: ss 26-52 and 26-53 (bribes to public officials) and s 26-54 (loss or outgoing in pursuance of a serious illegal activity).

At times, the deduction denial provision is only directed at denying part of a deduction otherwise available. A number of these provisions will usually cap the deduction at a "market value". For example, s 70-20 reduces the deduction to the market value of the trading stock purchased where the taxpayer has paid an inflated price for the trading stock under a non-arm's length transaction. Section 26-35 does a similar thing in regard to excessive payments made to a relative for their services.

Some provisions that look like deduction denial provisions are really only "deduction deferral provisions". Subsection 26-10(1) is in this category (no deductions for annual leave, long service leave, etc, until the amount is paid). Sections 82KZM and 82KZMD of the ITAA 1936 are also in this category (deduction for pre-paid expenditure deferred over the period to which the expense relates).[63]

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[58] Subsection 40-880(5)(b).

[59] There are times where the cost base is not relevant in calculating a gain or loss on a CGT event (e.g. CGT event D1, CGT event F1). In these circumstances though, the taxpayer is permitted to take costs of the event into account in calculating the gain or loss.

[60] Subsection 40-880(5).

[61] There is no guidance on how to determine the most appropriate provision, but thankfully, in many cases, it will not matter because both sections will give the same amount of deduction and give it at the same time. It is also worth mentioning another anti-double cost counting provision, namely, s 82 of the ITAA 1936. This section prevents an expense being taken into account in working out the profit or loss that is assessable income or deductible respectively on a transaction, where the expense is a deduction in its own right.

[62] This is not always the case though. There are some deduction denial provisions that are denying deductions that would otherwise arise outside of the general deduction section (e.g. s 26-55).

[63] The deduction quarantining rules (or tax loss quarantining rules) in ss 26-47(2) and 35-10(2) could also be viewed as deduction deferral rules.

A feature of a number of deduction denial provisions is that many of them only apply to taxpayers that are carrying on a particular income activity (e.g. business, non-business).

There are a small number of examples though where a deduction denial provision seems to have a limited role (if any role) because the expenditure does not appear to come within a deduction conferral section in any event.[64] The deduction denial provision is often designed to make absolutely certain that a deduction is not available.

2.2.3.1 Some Deduction Denial Regimes are often complicated by Exceptions to the Deduction Denial

The reason for complication is that while these regimes contain a deduction denial rule, they also contain exceptions to the deduction denial rule. This can make it difficult to characterise the rules, or the role of the rules within these regimes. In spite of the presence of exceptions to the deduction denial rule, these regimes must still be seen as deduction denial regimes, rather than as deduction conferral provisions. The rules (regimes) dealing with: (1) entertainment expenditure[65] and (2) non-compulsory uniforms[66] can be put into this category.

2.2.4 Cost Base of CGT Asset or other Cost Recognition under CGT Regime

The cost base or reduced cost base of a CGT asset is the main source of recognition for expenditure under the CGT regime.[67] This aspect of the CGT regime corrects for the fact that expenditure included in the cost base would not otherwise receive recognition under the general deduction section or under a specific deduction section.

The cost base, which is used when calculating a capital gain, contains five elements, and those elements are exhaustive of what can be included.[68] The first element is the acquisition cost of the asset. For the second element, which deals with incidental costs associated with the purchase and sale of the asset, there is a list of 10 items, and these are exhaustive (i.e. must fit within them otherwise not included).[69] The items listed in

[64]The most obvious example is s 26-5, which purports to deny deductions for fines and penalties for breaking the law. On the authority of *Mayne Nickless Ltd v FCT* 84 ATC 4458 and *Madad Pty Ltd v FCT* 84 ATC 4739, these types of expenditures are not likely to satisfy the general deduction section. Section 26-40 may provide another example of this, namely, expenses to maintain your spouse or child under 16-years. These expenses, in the great majority of cases, would not satisfy s 8-1. A similar point can be made in regard to s 26-45 (recreational club membership fees) for many taxpayers. A similar point could be made in regard to s 51AH of the ITAA 1936 because the general deduction section does not generally confer a deduction where the taxpayer is not beneficially incurring the expense.

[65]Sections 32-5 to 32-50.

[66]Sections 34-5 to 34-65.

[67]There are a small number of situations where cost recognition is given through a CGT event not involving a cost base (e.g. CGT event D1: s 104-35, CGT event F1: s 104-110).

[68]Section 110-25.

[69]Subsection 110-25(3) and s 110-35. Section 110-35 provides these examples: (1) Remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser (2) Stamp duty or other similar duty (3) Costs of advertising or marketing to find a buyer or seller and (4) Borrowing expenses (such as loan application fees and mortgage discharge fees).

the third element, which deals with costs of owning the asset, while not legally exhaustive, probably cover most expenses that would come within the third element.[70] One necessary requirement of the fourth and fifth elements is that the expenditure is capital.[71]

The reduced cost base, which is used when calculating a capital loss, is essentially the same as the cost base with two qualifications.[72]

There is no express ordering rule in the CGT regime. That is, there is no rule stating that the problem solver needs to apply the general deduction section or a specific deduction section before applying the cost base inclusion rule, or the other way around. However, there is a rule or collection of rules that state, where expenditure is deductible, that expenditure cannot be included in the cost base of the CGT asset.[73] In one sense, this serves as an ordering rule that makes CGT asset cost base inclusion last in terms of priority. However, it is worth noting a prominent exception to this, namely, CGT asset cost base inclusion takes priority over deductions under s 40-880.[74] The rules prohibiting cost base inclusion where a deduction has been obtained can also be seen as anti-double cost recognition.[75]

3. DEFECTIVE TAX PROBLEM SOLVING FROM A "NON-ORDERED APPROACH"

This part is broken up into "Receipts, Profits, Gains or Benefits" (Sub-Part 3.1) and "Expenses, Outgoings or Losses" (Sub-Part 3.2). The idea is to list some examples involving defective tax problem solving. Part 4 may require a more detailed analysis of the errors in the context of setting out the suggested ordering approach to the tax rules.

3.1 Receipts, Profits, Gains or Benefits

This sub-part groups error types into three broad categories.

[70]Subsection 110-25(4). Subsection 110-25(4) provides these examples: (1) Interest on a loan to purchase the asset (2) Costs of maintaining, repairing or insuring the asset and (3) Rates or land tax, if the asset is land.

[71]Subsections 110-25(5) and 110-25(6).

[72]Third element costs are not counted under the reduced cost base: ss 110-55(1) and 110-55(2). Further, and of lesser importance as time goes on, no elements in the reduced cost base can be indexed for inflation: s 110-55(1).

[73]Subsections 110-45(1B) and 110-45(2) achieve this for assets acquired (generally) after 12 May 1997. Section 110-40 deals with assets acquired (generally) before 14 May 1997. The rule for exclusion of deductible amounts from the reduced cost base is in s 110-55(4).

[74]Subsection 40-880(5)(f).

[75]The cost base exclusion rules (ss 110-40 and 110-45) are required because s 8-10 (anti-double deduction rule) cannot apply where recognition is not solely under deduction provisions, which is the case with cost base inclusions.

3.1.1 Application of a Provision that contains the Descriptive Receipt Item (Examples 1-5)

This is a very common mistake. In short, the error involves the problem solver being "attracted" to a specific assessable income section because the receipt is listed in the specific assessable income section.

3.1.1.1 Subsidy to Business: Example 1

Where a taxpayer receives a subsidy in relation to carrying on their business,[76] it may not be correct to state that s 15-10 apples to include the subsidy in assessable income. One requirement of s 15-10 is that the subsidy must not be income.[77] If it is income, which many subsidies will be because they will be the product of a business,[78] s 15-10 cannot apply, and s 6-5 will apply.

3.1.1.2 Lease Repair Covenant Receipt: Example 2

A taxpayer, former lessor of commercial property, receives a lease repair covenant payment from a defaulting former lessee. The statement that s 15-25 applies to include the amount in the taxpayer's assessable income will usually be correct. However, one of the conditions for s 15-25 to apply is that the amount is not income.[79] If it is income, s 15-25 cannot apply. In most cases, such a receipt will not be income, but in some it may.[80]

3.1.1.3 Royalties and Compensation Receipts: Examples 3, 4 and 5

The observations made above in regard to business subsidies and lease repair covenant receipts are equally relevant to receipts of royalties (s 15-20), compensation for lost assessable income (s 15-30) and compensation for lost trading stock (s 70-115). For these three types of receipts though, it is near certain that they would be income on ordinary concepts and therefore s 6-5 would apply, and not the specific assessable income section mentioned.

3.1.2 Sale of Asset that fits within an Asset Regime (Examples 6 and 7)

This category is similar to the errors in Sub-Part 3.1.1, but it does require a separate treatment because the transaction forms part of a "bigger" regime where one aspect of the regime involves a charging provision.

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[76] A "business" is not an entity or an artificial person; it is merely an activity. Accordingly, a business cannot receive a subsidy. A company s an artificial (or legal) person, and a company can operate a business. A company can also "carry on" the activity of holding passive investments.

[77] Subsection 15-10(b).

[78] See discussion in *Reckitt & Colman Pty Ltd v FCT* 74 ATC 4185 at 4186-4191.

[79] Subsection 15-25(d).

[80] The note under s 25-15 contemplates that the receipt of such a payment may be income.

3.1.2.1 Sale Proceeds for Depreciating Asset: Example 6

Upon the sale of a depreciating asset, that is, an asset that has attracted decline in value deductions under s 40-25, students often commence (and complete) their analysis of the sale transaction at s 40-285. This section requires a comparison of the "termination value" and the "adjustable value" to determine if an assessable income gain inclusion is made, or a deductible loss is made. The termination value of the asset does not include an amount included in assessable income under s 6-5.[81]

While not common, s 6-5 will apply where the asset is a revenue asset and the asset is sold for an amount above its cost of purchase.[82] Where this is the case, the answer obtained solely under s 40-285 will not be correct because the amount above original cost will be included in assessable income under s 6-5. The overall answer though in terms of the assessable income inclusion will be correct.[83] A related error, sometimes made, is that students' claim that the sale proceeds for a depreciating asset are on capital account (not income) because the sale transaction is dealt with under Division 40.

3.1.2.2 Sale of CGT Asset: Example 7

Where a taxpayer sells a CGT asset, and therefore the transaction fits within the key CGT event (CGT event A1), an analysis that focuses solely on determination of a gain or loss under the CGT regime may be incorrect. It will be correct where the gain is not income, and not caught by a specific assessable income provision outside the CGT regime. However, without actually undertaking the income-capital analysis under s 6-5, the problem solver has not shown that the gain is not income. And, if the gain is income, the CGT answer will not be correct because the effect of s 118-20 has not been taken into account. Section 118-20 reduces the capital gain by the income amount so as to prevent double taxation, once under s 6-5 and again under the CGT regime. The incorrect answer has considerable significance for the taxpayer and the ATO because many capital gains made by individuals are discounted by 50% (i.e. only taxed on half the gain).[84] Income gains (s 6-5) cannot be discounted.

Another common problem is to deal with the sale of a depreciating asset (asset subject to s 40-25 decline in value deductions), which will also be a CGT asset, under the CGT regime. This leads to an incorrect answer as there is a provision dealing with such sales under Division 40,[85] and the gain or loss from such sales are excluded from

[81]Subsection 40-300(3).

[82]See *Memorex Pty Ltd v FCT* 87 ATC 5034 and *FCT v GKN Kwikform Services Pty Ltd* 91 ATC 4336 for examples of revenue assets that also attracted depreciation deductions (i.e. depreciating assets) being realised for amounts above original cost.

[83]For example, the sale of a depreciating asset which is a revenue asset of the taxpayer and which had: (a) sale price of $10,000 (b) purchase cost of $8,000 and (c) adjustable value (tax written down value) at the date of sale of $5,000, would give rise to an assessable income inclusion of $5,000. Of this $5,000, $2,000 ($10,000 - $8,000) will be included under s 6-5 and $3,000 ($8,000 - $5,000) will be included under s 40-285(1). If the asset were not a revenue asset, s 40-285(1) would include the whole $5,000 ($10,000 - $5,000) in assessable income.

[84]Step 3 of Method Statement in s 102-5(1) and s 115-5.

[85]Section 40-285. It should also be noted that the problem solver should have started at s 6-5.

the CGT regime.[86] Like that immediately above, the incorrect answer has considerable significance for the taxpayer and the ATO because many capital gains made by individuals are discounted by 50% (i.e. only taxed on half the gain).[87] Non-CGT assessable income amounts (s 40-285) cannot be discounted. Of further significance, capital losses under the CGT regime can only be used against capital gains (under CGT regime). A deduction under s 40-285 can be used against all assessable income amounts.

3.1.3 Focus Solely on Exemption Component within a Taxing Regime: Example 8

The taxpayer purchased a home as a residence in 1984. She lived in the home until 2000, and then rented it out for the next 11-years before selling it in 2011. She made a profit on the sale. An answer to the tax question raised by the sale transaction that focused solely on the gain disregard regime for main residences in the CGT regime[88] is likely to lead to an incorrect answer.

Under the main residence provisions, the taxpayer will only be eligible for a partial exemption on the gain made because the dwelling was not her main residence at all times during her ownership period.[89] This could lure the problem solver into thinking that part of the gain is a [chargeable] capital gain because only part of the gain is exempt under the main residence regime. This would be incorrect because the gain does not satisfy one key positive criterion of the charging provisions in the first place, namely, that the asset is acquired after 19 September 1985.[90]

3.1.4 Focus narrowly on one Deficiency in Ordinary Income Concept: Example 9

A taxpayer who is not an employee, but who is rendering services (e.g. independent contractor) but not in the form of a business, receives a non-cash benefit that cannot be converted into money. The problem solver correctly states that the benefit cannot be income. However, often the problem solver goes on to state that s 21A of the ITAA 1936 overcomes the non-convertibility doctrine under s 6-5 and therefore the arm's length value of the benefit is included in assessable income. The answer is technically incorrect because s 21A only deals with a business taxpayer. The correct answer would have been that s 15-2 applies.

3.2 Expenses, Outgoings or Losses

This sub-part groups error types into two broad categories and a miscellaneous category.

[86]Section 118-24.
[87]Step 3 of Method Statement in s 102-5(1) and s 115-5.
[88]Subdivision 118-B.
[89]Subsection 118-185.
[90]Subsection 104-10(5)(a). I will ignore the controversy created by s 118-192, namely, the possibility that the section "transforms" or "rolls forward" the acquisition date of a pre-CGT residence to a post-CGT acquisition date.

3.2.1 Application of a Provision that contains the Descriptive Expenditure Item (Examples 10-13)

Similar to the problem under receipts or profits above, this is a very common mistake. In short, the error involves the problem solver being "attracted" to a specific deduction conferral section or an element of the cost base of a CGT asset, because the expenditure is listed in the specific deduction conferral section or the element of the cost base.

3.2.1.1 Theft of Money by Employee: Example 10

An answer that suggests that s 25-45 will apply to confer a deduction is likely to be correct in most cases. However, there is nothing preventing this transaction from being a deduction under s 8-1.[91] Indeed, and even though debatable, it is unlikely that the criteria for deductibility under s 8-1 in regard to a theft of money will be as restrictive as the criteria set out in s 25-45 (e.g. theft must be by employee or agent, money must have been included in assessable income). In addition, if both s 8-1 and 25-45 apply, the problem solver has not resolved the double deduction issue by reference to s 8-10.

3.2.1.2 Interest on Loan, Rates and Land Tax and Repairs to Property that is a CGT Asset: Example 11

Where a taxpayer incurs these expenditures in regard to an income producing rental property, an analysis that states that the expenditures are included in the third element of the cost base of the property for CGT purposes is completely incorrect. These items are expressly mentioned in the third element.[92] However, the problem-solver has failed to consider deduction sections that may apply (will apply) to the expenditure, which in turn means the problem solver has failed to consider the cost base exclusion rule for deductible expenditure. Even though it is not a material error, the problem solver has also failed to deal with a specific deduction conferral section that expressly deals with repairs.[93]

3.2.1.3 Stamp Duty on Purchase of Income-Producing CGT Asset, Legal Fees for Solicitor, Borrowing Expenses: Example 12

These expenses are associated with the purchase of an asset, a CGT asset. The analysis here is often along the lines that these expenses are included in the second element of the cost base of the asset because they are expressly listed in s 110-35. At times, the comment is also made that they are capital expenditure and that is the reason why they are included in the cost base.

There are many errors here. It is true that all three expenses are expressly covered by the second element of the cost base. However, just like immediately above, the problem-solver has failed to consider deduction sections that may apply to the expenditure, which in turn means the problem solver may also have failed to consider

[91]The reasoning and decision in *Charles Moore & Co (WA) Pty Ltd v FCT* (1956) 11 ATD 147 would provide a strong authority.
[92]Subsection 110-25(4).
[93]Section 25-10.

the cost base exclusion rule for deductible expenditure. This will be the case at least in regard to the borrowing expenses. They are deductible under s 25-25. And there is no analysis as to why s 8-1 does not apply to any of the expenses, which may have meant that the borrowing expenses also satisfied s 8-1. Further, there was no analysis as to why each expense was capital. And, in any event, there is no requirement that expenditure must be of a capital nature for it to be included in the second element of the cost base.[94]

3.2.1.4 Travel Expenses from Home to a Workplace: Example 13

Where a taxpayer, who is "on call" like the taxpayer in *FCT v Collings*[95] (i.e. work begins at the time the taxpayer receives a phone call at home from their employer), travels "to" work, an analysis that states that the taxpayer is denied a deduction for the travel costs because of s 25-100(3) is incorrect. Subsection 25-100(3) states that travel between 2 places is not "travel between workplaces" if one of the places you are travelling between is a place at which you reside (home).

The error here is that s 25-100(3) is only relevant to s 25-100; indeed, the only thing s 25-100(3) does is provide an exception to the "travel between workplaces" concept. The taxpayer in *FCT v Collings* is obtaining her deduction under s 8-1, not s 25-100. Section 25-100 remains irrelevant to the operation of s 8-1.[96] The other error that this reasoning reveals is that a specific deduction conferral section is being viewed as a deduction denial section.

3.2.2 Analysis Commences at a Deduction Denial Regime (Example 14)

This is also a common mistake. Similar to the above category of errors, this error is largely based on the idea that the problem solver is "attracted" to the deduction denial regime because the expenditure fits the description in that regime. Only one example is provided.[97]

3.2.2.1 Entertainment Expenditure: Example 14

The suggestion is often made that s 32-45 provides a taxpayer with a deduction for entertainment expenses (e.g. providing *entertainment to promote or advertise to the public a *business or its goods). This analysis is incorrect. Section 32-45 does not confer a deduction; it is not a specific deduction conferral section. Section 32-45, in combination with s 32-25, merely "restores" a deduction that has been denied by operation of s 32-5. Section 32-5 contains the deduction denial rule. The relevant part of s 32-5 reads: "To the extent that you incur a loss or outgoing in respect of providing

[94]One would expect however that most of the expenses that come within the second element of the cost base would, most of the time, be of a capital nature because of the requirement in s 110-35(1) that the expenses be incurred to acquire a CGT asset or they were incurred in relation to a CGT event (usually a sale).

[95]*FCT v Collings* 76 ATC 4254.

[96]Another mistake is to analyse travel expense situations under s 25-100, presumably because s 25-100 uses the word "travel". The incorrect analysis is limited to s 25-100, even when the taxpayer only has one income activity.

[97]Another example that could be provided involves the non-compulsory uniform rules in Division 34.

*entertainment, you cannot deduct it under section 8-1." The words: "Section 32-5 does not stop you deducting…" in s 32-25 is the authority for this. Restoring a deduction is the only role of s 32-45 (in combination with s 32-25). Therefore, the conferral of a deduction for entertainment expenditure must come from the general deduction section (s 8-1) there being no other section conferring a deduction for such expenditure. This is also the clear implication from s 32-5.

One question is, does this incorrect reasoning lead to an incorrect answer on the deductibility question? The answer is probably not, but this would be through "good luck", rather than sound tax problem solving. The key point is that when one examines the three circumstances in s 32-45, all of those situations described would seem to satisfy the general deduction section.[98] Let me repeat though, our problem solver has not applied s 8-1, the only possible deduction conferral section, to the relevant expenditure. The problem solver will not end up at the correct conclusion where the described circumstances do not satisfy s 8-1.

The point made about s 32-45 can equally be made about ss 32-30 to 32-40 and s 32-50, other provisions within the entertainment deduction denial regime.

3.2.3 Miscellaneous Errors (Examples 15-17)

3.2.3.1 Capital Requirement in Capital Allowances Regimes or CGT Cost Base Elements Forgotten: Example 15

Often an answer is given that a capital allowance regime applies to provide a deduction for expenditure. Similarly, CGT asset cost base inclusion via the fourth and fifth element is also provided as a solution for an expenditure item. Rarely do these sorts of answers address the requirement in the capital allowance regimes and the fourth and fifth elements of cost base that the expenditure must also be of a capital nature to come within those regimes/provisions. Also, in many cases the revenue-capital character of the expenditure was not even addressed under s 8-1.

3.2.3.2 Expenditure Items are Capital because they fit the Description in a Capital Allowance Regime or Cost Base Element: Example 16

This is a common error in tax reasoning, yet the error does not necessarily lead to an error in the solution. For example, it is often said that because an item of expenditure fits within an element of the cost base, the expenditure must be capital under s 8-1 or s 25-10 (repair section). Clearly, this reasoning is incorrect. There is nothing in the legislation (or logic) that suggests this is a valid approach to the tax rules.

In many cases, expenditure items that come within the cost base will be capital expenditure, but the obvious point is that there will be times when they are not. This is where solutions will be incorrect.

[98]There is an outside chance that an initial one-off promotion and advertising expenditure might give rise to a capital outgoing (and therefore not satisfying s 8-1) on the basis of the reasoning in *Associated Newspapers Ltd v FCT; Sun Newspapers Ltd v FCT* (1938) 5 ATD 87 at 94.

3.2.3.3 Capital Allowance Regimes not considered where Capital Repair Expenditure involved: Example 17

The mistake often made is that no thought is given to including expenditure in the "cost base" recognition rule under Division 40[99] or Division 43[100] once the expenditure has been found to be capital under s 25-10. Instead, the usual response is to include the capital expenditure in the fourth element of the cost base under the CGT regime. This has also been the response where the only asset involved is a depreciating asset within Division 40 (s 40-30). It will be appreciated that, effectively, depreciating assets used 100% for income production are outside the CGT regime.[101]

4. NATURE OF TAX PROBLEM AND ORDER OF APPROACH TO THE TAX RULES FOR PROBLEM SOLVING

4.1 Key Questions for Taxpayers (and Students) and the Nature of the "Problem"

The income tax is a transaction tax in the sense that the taxable event that tax rules apply to is usually the transaction entered into by the taxpayer. In a first income tax course, the key issues for students are: (1) When does a receipt or profit enter taxpayers' assessable income and (2) When do taxpayers obtain a deduction or recognition (e.g. inclusion in cost base of a CGT asset) from the tax rules for costs or expenses incurred or paid. Obviously, a first tax course also deals with some other matters. For example, when is a benefit received by an employee taxed under the fringe benefits tax regime, rather than in the hands of the employee; is a taxpayer entitled to a tax offset; what is the amount of tax payable. Some of these examples however also involve the assessable income inclusion question (e.g. benefit received by an employee). Overall though, the inclusion of amounts in assessable income, and the inclusion of amounts in deductions or other cost recognition provisions from transactions entered into by the taxpayer is the central focus.[102]

As will be apparent from Part 2, the difficulty facing the problem solver is that there is not just one assessable income section in the income taxation law, and there is not just one deduction section. Further, there is a mixture of general sections, that are not limited to particular receipts or expenses, and specific sections that deal with particular receipts and expenses. This means that, in the case of a receipt or profit, the transaction may have to be analysed under more than one assessable income section. At times there is specific and express co-ordination between sections, but at other times the co-ordination is not obvious. The approach to co-ordination between the non-CGT assessable income provisions and the CGT regime is not always the same. Similar observations can be made in regard to outgoings, expenses or losses. Indeed, the co-ordination problems are even more difficult here. For example, there are times

[99] Section 40-190 (second element of cost base of depreciating asset).
[100] Sections 43-10 and 43-70 (construction expenditure for capital works).
[101] Section 118-24.
[102] This is generally the case even where the determination of the "taxable income" of a partnership, trust estate or a company is involved.

where two sections operate in tandem to facilitate the conferral of a deduction to the taxpayer.[103] This is very uncommon for an assessable income inclusion.[104]

The challenge is to adopt an approach to the tax rules that takes account of the multiple sections that can apply to a transaction, the nature of the various sections that can apply to a transaction and the differing approaches to co-ordination between sections and regimes. This is the only way to maximise the chances of more correct answers on a consistent basis; correct answers being those that equate with the legislative intent for the relevant taxpayer's transaction. The suggested approach is directed at this. At the same time, it is hoped that the approach adopted facilitates deeper understanding of the tax rules.

4.2 Order of Approach to Tax Rules when dealing with Receipts, Profits, Gains or Benefits

The presence of the fringe benefits tax regime, where a central criterion is an employment relationship, requires the approach in regard to receipts or benefits to be broken into two.

4.2.1 No Employment Relationship

4.2.1.1 Ordered Approach

The following steps are the suggested order of application of the tax rules where there is no employment relationship between the payer and payee (taxpayer). Note also the ordered approach within each regime/section within each step:

1. The ordinary income section (s 6-5);
2. Specific assessable income sections (e.g. ss 15-2, 15-10 and 40-285), aside from the capital gains tax regime;
3. Exempting provisions (outside the CGT regime); and
4. The capital gains tax regime.

Importantly, where the problem-solving forum for the tax course permits (e.g. tutorial; seminar; to a lesser extent, written assignments), it is suggested that all of the above steps are engaged in, even where s 6-5 applies (Step 1) to include an amount in the taxpayer's assessable income.[105]

Importantly, in regard to Step 1, the analysis ought to be comprehensive in the sense that the key positive criteria and the key negative criteria of the income concept are considered in turn. The reason is that the specific assessable income sections and the CGT regime correct for deficiencies (not all) in the income concept so that many of

[103] Where expenditure on capital works on a CGT asset is involved, part of the expenditure may be deductible and the other part may be included in the cost base of the CGT asset.

[104] The combination of s 6-5 and s 21A of the ITAA 1936 in regard to non-cash business benefits may provide one example involving assessable income inclusions.

[105] Certainly, in an exam or test situation, time may not permit the full analysis that would otherwise be possible in a tutorial or seminar discussion. In these circumstances, lecturers may be content to assume that by coming to the correct answer, you have undertaken, at least mentally, the relevant analysis.

the central concepts/criteria (both positive and negative) are adopted or corrected for in specific assessable income sections and the CGT regime. The main deficiency (or deficiencies) not corrected for are the mere gift and personal recognition situations (i.e. not taxed). In short, it is suggested that it is more likely that better quality problem solving will take place under the specific assessable income sections where the problem solver brings the "full picture" from s 6-5 to the specific assessable income section (Step 2), and for that matter, Steps 3 and 4.[106] The idea is that where the problem solver has formed a view about the taxpayer's activity or transaction under general principles (s 6-5), it is harder for that problem solver to erase or contradict that view when undertaking the required analysis under a specific assessable income section. One needs to bear in mind that specific assessable income sections can provide new "distractions" for the problem solver.

For example, take a taxpayer that owns a rental property and who is deriving passive property income (not income from a business). The taxpayer receives a subsidy to assist with extending a building on the property. It is likely that the subsidy will be capital under s 6-5. If the problem solver also observes or notes when undertaking the s 6-5 analysis that the taxpayer's rental property activity is not a business, the problem solver is likely to bring that non-business conclusion into the s 15-10 analysis and therefore, in all probability, avoid the error of concluding that s 15-10 applies to the subsidy. The problem solver who merely concludes under s 6-5 that the subsidy is capital will be starting the s 15-10 analysis from scratch. This will not necessarily lead to an error because the problem solver may simply undertake a comprehensive analysis of the passive property income-business distinction under s 15-10.

One the other hand, there is a danger with the full picture approach. The danger is that the problem solver may make the mistake of "transporting" criteria that is only relevant to s 6-5 into the criteria for a specific assessable income section. A very common mistake is to transport the non-convertibility doctrine under s 6-5 into a criterion under s 15-2. The problem solver needs to guard against this type of error.

A similar approach to that taken in Step 1 ought to be also taken in Step 2. Many specific assessable income sections have a positive requirement(s) and a negative requirement(s). Like the approach to the positive and negative criteria within the ordinary income section, it is suggested that the positive and negative requirements of specific assessable income sections are analysed in turn.

Very few exempting provisions (outside the CGT regime) are considered in a first income tax course (Step 3).

A similar approach to that taken in Step 2, albeit modified, can be taken in regard to Step 4. That is, the focus should first be on CGT events, and the rules therein, that give rise to a gain or loss. CGT events can also be regarded as the positive criteria even though the sections that contain each CGT event also contain the pre-CGT asset

[106]It will be appreciated that having the "full picture" in regard to the taxpayer's activity also provides assistance in regard to cost recognition questions: see below.

acquisition exclusion.[107] And within the "positive criteria", the correct ordering approach to CGT events within the CGT regime should be adopted (i.e. CGT events dealing with pre-existing assets first, then CGT event D1 and then CGT event H2). Only after the analysis of the positive requirements of the CGT regime (CGT events) is consideration of gain disregard or loss disregard rules (exemptions or exclusions) required. This could also be regarded as negative criteria.

4.2.1.2 Justification for Ordered Approach

The central justification for the suggested approach is that its application is more likely to lead to a correct answer to a tax problem, or is less likely to lead to errors. The reason is that the approach, where properly followed, should permit a comprehensive analysis of the problem whereby all provisions or regimes or rules within regimes that can govern the tax outcome of the transaction are considered. Indeed, the ordered approach is likely to be the only way in which co-ordination between the rules can be achieved; properly applying the interaction between regimes to a transaction will in many cases be necessary to achieving a correct answer.

This does not guarantee a correct answer to a tax problem because the problem solver still has to identify the relevant rules, determine the scope of those rules and deal with characterisation issues within those rules. The ordered approach suggested here does not assist, and is not intended to assist, in this regard. Further, the suggested approach will not necessarily be superior to other approaches for all problem solvers, all of the time, because the problem solver using another approach may end up with the required coverage of relevant provisions in any event. For example, a problem solver might commence at the CGT provisions first and conclude that the profit on the sale of an asset is a capital gain. Then, he or she "may" work through s 118-20 (anti-double taxation provision), which may have the effect of pointing the problem solver back to s 6-5 to see if the gain is income. This problem solver may end up at the correct answer, but it is not clear what system the problem solver is employing so that achieving comprehensiveness on a consistent basis is less likely. The ordered approach in this article is far more coherent, it has a system to it and it is directed at comprehensiveness, which is essential in problem solving in a first income tax course. Other approaches do not have coherence, and they are not directed at comprehensiveness.

It is also suggested that the approach in this article should lead to a deeper understanding of the income tax law regarding receipts or profits. The reason is that the approach is better aligned with the history in the growth of, or introduction of, assessable income provisions and/or the expansion of taxpayers' tax base, and therefore is more likely "to teach" the context of the relevant charging provisions. Most of the specific assessable income sections and the CGT regime are a response to the narrowness of the income concept, and exempting provisions are a response to the

[107] It does not matter much whether the exclusion or exemption of a capital gain or capital loss when the taxpayer acquired the asset before 20 September 1985 is seen as part of the positive or negative criteria. It is probably more convenient to regard the rule as part of the positive criteria because the rule is located in close proximity (same section) to the CGT event rule: see s 104-10(5) for CGT event A1, s 104-25(5) for CGT event C2.

broadness of the income concept. This is part of the context and background to the introduction of these provisions. The key point is that the suggested approach to the charging rules roughly reflects the introduction and development of the charging provisions within the income tax. It is difficult, if not impossible to make this assertion with another less ordered approach.

In regard to the claim that less errors will be made by using the ordered approach, let us consider the examples in Sub-Part 3.1. Most of Examples 1-5 involve the error of applying the incorrect assessable income section to a particular receipt (e.g. subsidy to a business); instead of applying s 6-5, the specific assessable income section was applied. Is the error of applying the incorrect assessable income section significant? In one sense, the answer is no, because the amounts in Examples 1-5 are still included in assessable income.

However, the problem solver is adopting a sub-standard or poor approach to tax problem solving. First, the correct assessable income provision (s 6-5 here) may have a different timing rule to the incorrect provision as to when the receipt is included in assessable income. Secondly, the problem solver is getting into the dangerous and incorrect practice of applying an assessable income section to a transaction when all the criteria for the application of the section are not satisfied. Thirdly, the problem solver may also be adopting an approach to assessable income sections that focuses on the description of a particular receipt. This is dangerous because the great majority of receipts do not have an assessable income provision specifically for them.[108] The income section, which is not limited to particular receipts, is the only non-CGT charging provision that can apply to these, great majority of receipts. The problem solver could get into the habit of limiting his/her focus to assessable income provisions that deal with particular receipts. Fourthly, the problem solver is denying himself/herself the opportunity to appreciate, or at least question, the role of the specific assessable income sections and s 6-5 in regard to the relevant receipt, and thereby losing an opportunity to deepen their understanding of the income tax law.

The sub-standard approach to problem solving is also present in Examples 6 and 7, and therefore most of the criticisms re Examples 1-5 above are also relevant. The error in Example 6 is similar in effect to the errors in Examples 1-5 (i.e. amount included as part of sale proceeds of depreciating asset instead of being included in assessable income under s 6-5, and then excluded from sale proceeds).

Example 7, which contains two examples, involves the problem-solver "heading straight" to the CGT regime. In regard to the first example within Example 7, most times, this will not result in an incorrect answer. But this would be through good luck (i.e. profit is not income), rather than through deliberate and considered application of the tax law by the problem solver. In regard to the second example within Example 7, this will lead to incorrect answers. There will be no "good luck" correction here.

[108]The tax legislation would have to be much longer than its already long length.

In Example 8 (sale of main residence), the problem solver has failed to apply the positive criteria within the CGT regime, in particular, CGT event A1, to determine whether a capital gain arises in the first place. Instead, the problem solver has proceeded straight to the main residence exemption regime, which of course invites the assumption that aside from the exemption regime, a taxable situation arises.

Put shortly, it is less likely that the errors in Examples 1-8 would be made if the problem solver adopted the ordering approach suggested in this article.

The error in Example 9 might not end up in an incorrect overall result because the valuation rule under s 21A of the ITAA 1936 might give an amount that roughly equals the s 15-2 amount. Again though, this would be "good fortune" rather than good problem solving. The error involves the problem solver focusing narrowly on the correction to the deficiency identified under the income concept, namely, the non-convertibility doctrine for non-cash benefits. What the problem solver has failed to do is to identify that s 21A only applies to a business taxpayer. It is suggested that had the problem solver also reached a conclusion on the category of income activity when undertaking the s 6-5 analysis, the problem solver might have carried that information into the s 21A analysis, which may have lead to a correct answer. It is true that a comprehensive analysis of s 21A would have picked up the error. However, it is submitted that the problem solver is likely to be more alert to the scope of corrective provisions (s 21A in this example) if he or she has considered the key negative and positive criteria from the ordinary income provision.[109]

4.2.2 Employment Relationship

Where there is an employment relationship between the payer (provider) and payee, the starting point should be the FBT regime, and in particular, the definition of a "fringe benefit" in s 136(1) of the FBTAA. In other words, the approach should first be to determine the regime under which the benefit is to be taxed (i.e. FBT or non-FBT income tax)[110] so that the other regime can be excluded.

If the benefit comes within the definition of a fringe benefit, it will be taxed under the FBTAA and the employee recipient will not be assessed on the benefit.[111] For completeness, if the benefit is an "exempt benefit" under the FBTAA,[112] then there is no FBT on the benefit but in addition, the employee recipient will not be assessed on the benefit.[113] If however the benefit falls outside the definition of a fringe benefit, and outside the definition of an exempt benefit, then the focus switches to the ITAAs (non-

[109]Often the suggestion is made that s 15-2 overcomes the non-convertibility doctrine for a business taxpayer in receipt of a non-cash benefit. This is also incorrect because, while s 15-2 does overcome the non-convertibility doctrine, it only does so for a business taxpayer.

[110]The FBT regime is properly classified as a component part of Australia's income tax regime. The FBT regime is a tax on "income", using the term income in its broadest sense, or economic sense. The fact the tax is levied on the provider (employer) of benefits does not undermine this.

[111]Subsection 23L(1) of the ITAA 1936.

[112]There are numerous sections in the FBTAA that make certain benefits exempt benefits. For example, s 58P: minor and infrequent and irregular small benefits and s 58Z: taxi travel to or from the place of work.

[113]Subsection 23L(1A) of the ITAA 1936.

FBT income tax). This means that the approach to the tax rules set out in Sub-Part 4.2.1 above applies.

4.3 Order of Approach to Tax Rules when dealing with Expenses, Outgoings or Losses

4.3.1 Ordered Approach

The following steps are the suggested order of application of the tax rules when dealing with expenses or outgoings. Note also the ordered approach within each regime/section within each step:

1. The general deduction section (s 8-1);
2. Specific deduction conferral sections, or sections that provide a deduction (e.g. s 25-5, 25-25, 25-100, 30-15, 40-25, and 40-880), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction (or defer a deduction otherwise available in the current income year), that would otherwise satisfy a deduction conferral section (e.g. ss 26-20 and 26-35); and
4. The cost base of a capital gains tax asset.

Importantly, where the problem-solving forum for the course permits (e.g. tutorial; seminar; to a lesser extent, written assignments), it is suggested that all of the above steps are engaged in, even where s 8-1 applies (Step 1) to confer a deduction.

In regard to Step 1, the analysis ought to be comprehensive in the sense that the key positive criteria and the key negative criteria in s 8-1 are considered in turn. The reason is that the specific deduction conferral provisions, deduction denial provisions and the CGT cost base regime correct for deficiencies in the general deduction section (i.e. to narrow or to broad) so that many of the central concepts/criteria (both positive and negative) are adopted or corrected for in specific deduction conferral provisions, deduction denial provisions and CGT cost base provisions. In other words, it is submitted that it is best to have the full picture when completing the s 8-1 analysis and embarking on the analysis in Steps 2 to 4. Again, like the suggestion for receipts, the idea is that where the problem solver has formed a view about the taxpayer's activity under general principles in s 8-1, it is harder for that problem solver to erase or contradict that view when undertaking the analysis under a specific deduction section or CGT cost base rules. And, the key structures in s 8-1 do often form an important part of specific deduction sections and CGT cost base rules (e.g. relevance of expense to income production, capital character of expense, apportionment of expense).[114]

For example, take a taxpayer that incurs expenditure in opposing the grant of a licence to a new entrant into the taxpayer's business sector.[115] The expenditure is capital. If the problem solver also observes or notes when undertaking the s 8-1 analysis that the

[114]Given that the depreciating asset regime appears to be an exclusive code in regard to deductions on disposal of a depreciating asset (*Australia and New Zealand Banking Group Ltd v FCT* 93 ATC 4238 at 4277-4278), in effect, the Step 1 analysis in this article is by-passed. That is, no deduction is available under s 8-1 where the depreciating asset is sold for less than its cost of purchase.

[115]These were the facts in *Broken Hill Theatres Pty Ltd v FCT* (1952) 9 ATD 423.

expenditure is sufficiently relevant to the taxpayer's business, the problem solver is likely to bring that relevance conclusion into the s 40-880 analysis and therefore, in all probability, avoid the error of concluding that s 40-880 cannot apply because the expenditure is not related to the business. The problem solver who merely concludes that s 8-1 does not apply because the expenditure is capital will be starting the s 40-880 analysis from scratch. This will not necessarily lead to an error because the problem solver may simply undertake a comprehensive analysis of the s 40-880 business/non-business dichotomy.

A similar approach ought to be taken in regard to Step 2. Many specific deduction conferral sections have a positive requirement(s) and a negative requirement(s). Like the approach to the positive and negative criteria within the general deduction section, it is suggested that the positive and negative requirements of specific deduction conferral sections are analysed in turn.

A systematic approach ought to be taken in regard to Step 3 (deduction denial provisions). Some deduction denial sections or regimes solely contain a deduction denial rule. However, some contain a deduction denial rule but also exceptions to that deduction denial rule. It is suggested that for these regimes, you should start your analysis at the deduction denial rule, and only after that, should your analysis move to the exceptions to the deduction denial rule.

A systematic approach should also be taken in regard to Step 4. That is, the focus should first be on the positive elements of the cost base of a CGT asset that include an expense in the cost base or reduced cost base. From there, the analysis should move to the negative criteria whereby expenses are excluded from the cost base.

4.3.2 Justification for Ordered Approach

The central justification for the suggested approach is essentially the same as that given for receipts above; that is, it is more likely to lead to a correct answer to a tax problem mainly because the approach encompasses a comprehensive analysis to the problem whereby all provisions or regimes or rules within regimes that can govern the tax outcome of the transaction are considered. Indeed, an ordered approach is a higher priority in regard to expenses compared to receipts because of the fewer "mechanisms" built into the expense rules that correct for poor problem solving.

Again, the ordered approach suggested here does not guarantee a correct answer to a tax problem because the problem solver still has to identify the relevant rules, determine the scope of those rules and deal with characterisation issues within those rules. The ordered approach does not assist and is not intended to assist in this regard. Further, the ordered approach will not necessarily be superior to other approaches for all problem solvers because the problem solver using another approach may end up with the required coverage of relevant provisions in any event. For example, a problem solver might commence at the CGT provisions first and conclude that interest expenditure to purchase a rental property does come within the third element of the cost base. Then, he or she "may" work through s 110-45(1B) and note that the expenditure is excluded from the cost base if it is deductible (anti-double counting rule), which may have the effect of pointing the problem solver back to s 8-1 to

analyse whether the interest is deductible. This problem solver may end up at the correct answer, but it is not clear what system the problem solver is employing. The ordered approach in this article is far more coherent, it has a system to it and it is directed at comprehensiveness, which is essential in problem solving in a first income tax course. Other approaches do not have coherence, and they are not directed at comprehensiveness.

Consistent with the point made for receipts, it is suggested that the approach in this article should lead to a deeper understanding of the income tax law regarding expenses. The reason is that the approach is better aligned with the history in the growth or introduction of deduction and cost recognition provisions and deduction denial provisions and therefore is more likely to teach the context of the relevant provisions. Most of the specific deduction provisions and CGT cost base rules are a response to the narrowness of the general deduction section. Deduction denial regimes are a response to the broadness of the general deduction section. This is part of the context and background to the introduction of these provisions. The key point is that the suggested approach to expense rules roughly reflects the introduction and development of corrective deduction provisions within the income tax. It is difficult, if not impossible to make this assertion with another less ordered approach.

In regard to the claim that less errors will be made by using the ordered approach, let us consider the examples in Sub-Part 3.2. Examples 10-13 involve the error of applying a specific deduction or cost recognition rule because the rule identified deals with the relevant expenditure. The specific rule is applied to the exclusion of other rules that may apply to the expense. This approach could only be correct if the legislative intent was to exclude all other deduction and cost recognition provisions, including s 8-1. There is no indication that this was the intent of parliament. Thus, had the problem solver followed the ordered approach suggested, it is far less likely that the errors in Examples 10-13 would have been made.

Example 10 (theft by employee) does not lead to an error in one sense because the taxpayer is obtaining a deduction for the expense and it does not really matter whether that is under s 8-1 or s 25-45. However, by commencing and finishing the analysis at s 25-45, the problem solver is adopting an approach to deduction sections that focuses on the description of a particular expense (loss here). This is dangerous because the great majority of expenses do not have a specific deduction conferral provision for them. The general deduction section, which is not limited to particular expenses, is the only non-CGT cost recognition provision that can apply to these, great majority of receipts. The problem solver could get into the habit of limiting his/her focus to deduction provisions that deal with particular receipts. Another problem with commencing with a specific deduction conferral provision that deals with “theft of money” is to ask, why didn’t the problem solver apply another provision that deals with the theft of money, namely s 116-60? In other words, why did the problem solver choose to apply s 25-45, and not s 116-60? It is submitted that this is the problem associated with an approach that focuses on, in the first instance, with rules that deal with a particular expense.

The error in Example 14 involves the problem solver commencing and concluding their analysis at the exception rule to the deduction denial rule, within the deduction denial regime. As a matter of statutory interpretation, the exception to a deduction denial cannot confer a deduction on a taxpayer. Put shortly, this error is far less likely to have occurred if the ordered approach in this article was followed. In particular, if the ordered approach is followed, the problem solver should never elevate a deduction denial exception rule to being a deduction conferral provision.

The errors or failures in Example 15 (i.e. failure to address the requirement in the capital allowance regimes and the fourth and fifth elements of CGT asset cost base that the expenditure must be of a capital nature to come within those regimes/provisions) and Example 16 (i.e. the expenditure fits within a capital allowance regime and/or CGT asset cost base and therefore it must be capital under s 8-1) are far less likely to be made had the problem solver adopted the approach set out in this article. Addressing the revenue-capital issue under s 8-1 at Step 1 and carrying "that picture" into specific deduction conferral sections or cost recognition rules should correct for both of these errors.

4.3.3 Slight Variation where Repair Expenditure involved

Where the taxpayer incurs expenditure in "fixing something up", it is suggested that the order of application of the tax rules should roughly be the same as that set out above, except that s 25-10 should displace s 8-1 at Step 1. Indeed, it is suggested that the problem solver ignore s 8-1 in regard to repair expenditure transactions. The main reason is that the key structural aspects in s 25-10 are, by and large, the same as the key structural aspects of s 8-1 and that therefore the same deductible or non-deductible outcome should arise from given facts.[116] The common structural aspects are: (a) purpose of producing assessable income[117] (b) apportionment of expenditure into deductible and non-deductible parts where repaired asset only used partly to produce assessable income[118] and (c) capital expenditure is not deductible.[119] And, even though the three capital limbs (i.e. initial repairs, improvement, replacement of an entirety)[120] were developed in the context of the repair section, it is submitted that those concepts

[116]For the most part, the ATO agrees with this view. At paragraph 74 of Taxation Ruling TR 97/23, the ATO states:

"Generally speaking, section 8-1 produces the same result as section 25-10 in relation to the deductibility of repair costs. Section 8-1 has its own tests for deductibility. There may be occasions, however, where section 8-1 allows a deduction for repair expenditure that would otherwise not be deductible under section 25-10. Section 8-1 might allow a deduction, for example, after a taxpayer ceases to hold, etc., property for income purposes even though section 25-10 would not allow a deduction (see Placer Pacific Management Pty Ltd v FC of T 95 ATC 4459; (1995) 31 ATR 253)".

[117]Subsection 25-10(1).

[118]Subsection 25-10(2).

[119]Subsection 25-10(3).

[120]Strictly speaking (i) the improvement concept and (ii) the replacement of an entirety concept, deny the expenditure being a repair. However, the analysis of these two types of situations will usually result in the expenditure also being of a capital nature.

would have been developed under the general deduction section, in the absence of a repair section.[121]

In addition, because of the type of expenditure involved, a narrower range of specific deduction conferral sections will be relevant at Step 2. The suggested order therefore is:

1. The repair section (s 25-10);
2. Deduction conferral sections, or sections that provide a deduction (e.g. s 40-25, s 43-10), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction; and
4. The cost base of a capital gains tax asset.

The error in Example 17 (i.e. no thought given to including expenditure in the "cost base" recognition rules under Division 40 or Division 43 once the expenditure has been found to be a "capital repair") is far less likely to be made had the suggested order been followed.

5. CONCLUSION

The tax rules studied in a first income tax course suffer from a number of deficiencies including overlap in assessable income provisions, overlap in deduction or cost recognition provisions, a general lack of express ordering rules and the presence of regime co-ordination rules that are hidden. In spite of this, the core tax rules do have a conceptual structure and considerable coherence. There is a real need therefore for a problem solving approach that reveals the conceptual structure of and the coherence within the tax rules so that deficiencies in the legislation do not undermine good problem solving.

With the aim of revealing the conceptual structure of the main tax rules, coherence of the rules and the interaction between the main tax rules, this article did set out the nature of the main tax rules (Part 2). From there, the article gave a number of examples of defective problem solving from disordered approaches to the application of the main tax rules to given facts (Part 3). These disordered approaches took no account of the conceptual structure and the coherence embedded within the main tax rules. Part 4 then introduced the author's ordered approach to the application of the tax rules to problem situations. Largely against the background of the facts in the examples in Part 3, it was demonstrated that the author's ordered approach is likely to consistently lead to better problem solving compared to disordered approaches. The reasons for this is that the author's ordered approach takes account of the conceptual structure of the tax rules and the coherence within those rules, and it is the only approach that has comprehensiveness as a main element of the problem solving process.

[121]The discussion of the relevant principles in repair cases like *FCT v Western Suburbs Cinemas Ltd* (1952) 9 ATD 452 and *W Thomas & Co v FCT* (1965) 14 ATD 78 in large part, draws on the revenue-capital dichotomy.

APPENDIX

This appendix sets out the topics covered in the Taxation Law course taught by the author. The topics are very similar to those studied in other Australian income tax law courses. It is possible though that the coverage below is narrower than that at other universities because the author has, within the constraints of the accreditation requirements of the various professional accounting bodies, taken the decision to pursue depth across a narrower range of topics (i.e. the well over the lake).

SEMINAR ONE

1.1 Course Administration
1.2 Tax Policy
1.3 Administration of Australia's Income Tax Regime
1.4 Income Tax Formula and Calculation of Tax Payable
1.5 Jurisdictional Aspects of Australia's Income Tax
1.6 Fundamental Income Tax Principles
1.7 Approach to Solving Problems in Taxation Law

SEMINAR TWO

2.1 Receipts and Benefits from Personal Exertion: An Overview
2.2 Income as a Reward from Personal Exertion, or Product of Personal Exertion
2.3 Statutory Additions to Judicial Concept of Income from Personal Exertion
2.4 Integrating the Various Personal Exertion Regimes

SEMINAR THREE

3.1 Capital Receipts in Context of Reward for Personal Exertion
3.2 Introduction to the Capital Gains Tax
3.3 Receipts and Benefits from a Business: An Overview
3.4 Existence of a Business or a Money-Making Endeavour
3.5 Normal Proceeds of Business/Ordinary Course of Business/Normal Incident of Business/Revenue or Structural Assets of Business

SEMINAR FOUR

4.1 Isolated Business Ventures/Profit Making Undertakings or Schemes
4.2 Receipts and Benefits from Property: An Overview, and a Problem/Opportunity
4.3 Rent/Lease Returns
4.4 Interest
4.5 Compensation Receipts Principle: An Overview
4.6 Compensation Receipts Principle in Context of Personal Services
4.7 Compensation Receipts Principle in Business Context
4.8 Compensation Receipts Principle in Context of Property Income
4.9 Factorial Income Principle

SEMINAR FIVE

5.1 History of Capital Gains Taxation in Australia
5.2 Role of Capital Gains Taxation within the Income Tax Assessment Acts
5.3 Broad Outline of Australia's Capital Gains Tax

5.4 Paradigm/Model CGT Framework: Essential Elements of First Charging Provision of the Capital Gains Tax
5.5 Assets, Exempt Assets and Asset Classification
5.6 Acquisition and Disposal (CGT Events)
5.7 Timing Issues
5.8 Calculating Gain or Loss
5.9 Second Charging Provisions of the CGT Regime
5.10 Determining Taxable Gain and Integration with Non-CGT Provisions

SEMINAR SIX

6.1 Overview of Expense Recognition under the Income Tax Assessment Acts
6.2 Deductions: General Principles
6.3 Relevant Expenditure: Test(s) of Deductibility
6.4 Expense Apportionment

SEMINAR SEVEN

7.1 Personal/Non-Personal Boundary Expenditure

SEMINAR EIGHT

8.1 Contemporaneity Principle
8.2 Revenue/Capital Boundary
8.3 Capital Allowance Regimes

SEMINAR NINE

9.1 Other Deduction Conferral Provisions
9.2 Deduction Denial Provisions
9.3 Tax Accounting: An Overview
9.4 Tax Accounting for Trading Stock

SEMINAR TEN

10.1 Taxable Income obtained through "Entities": An Overview
10.2 Taxation of Taxable Income obtained through a Partnership: An Overview
10.3 Existence of a Partnership
10.4 Taxation of Partnership's Taxable Income/Tax Loss
10.5 Transactions between Partners, Transactions between Partners and "The Partnership" and Transactions between Partnership and Third Parties
10.6 Taxation of Taxable Income obtained through a Trust Estate: An Overview
10.7 Existence of a Trust Estate/Trust
10.8 Taxation of Trust Estate's Taxable Income

SEMINAR ELEVEN

11.1 Taxation of Taxable Income obtained through a Company: An Overview
11.2 Existence of a Company
11.3 Classification of Companies for ITAA Purposes: Private or Public
11.4 Calculation of Companies' Taxable Income or Tax Loss, and Tax Payable by Companies
11.5 Imputation System: Company's Perspective

11.6 Distributions to Shareholders
11.7 Distributions to Natural Person Shareholders
11.8 Distributions to Corporate Shareholders

SEMINAR TWELVE

12.1 Tax Avoidance Defined and Conditions that Facilitate Tax Avoidance/Tax Planning
12.2 Judicial and Legislative Responses to Tax Avoidance/Tax Planning
12.3 Australia's Goods and Services Tax: An Overview
12.4 Net Amount Formula under the GST Act
12.5 Notion of an Entity under the GST Act
12.6 Notion of a Taxable Supply
12.7 GST Free Supplies
12.8 Input Taxed Supplies
12.9 Notion of a Creditable Acquisition
12.10 Broad Operation of Fringe Benefits Tax Regime
12.11 Expense Payment Fringe Benefits
12.12 Interaction between GST, Income Tax and Fringe Benefits Tax