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Equal taxation as a basis for classifying financial instruments as debt or equity—a Swedish case study

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Abstract

This article examines the way in which classification of financial instruments as debt or equity has developed in the Swedish income taxation system over the past 25 years. Although the structure of the tax system is based on the assumption that debt instruments are financial instruments with low risk, legal developments have not shared that assumption, resulting in several types of high-risk derivative instruments being covered by the definition of legal debt. This article illustrates how those developments, which can be recognised in most income-tax systems within OECD countries, seriously threatens the fundament of the tax system: equal taxation for capital income and income from labour. The article concludes by illustrating how the standard solution to the problem of classifying financial instruments as debt and equity—by treating them alike—does not fulfill the challenged principle of equal taxation, but actually intensifies the development towards unequal taxation.

Keywords: *Debt, equity, derivatives, income tax, flat tax, financial theory, Swedish tax law, horizontal equity*

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1. INTRODUCTION

1.1 Equal or effective income taxation?

Although the history of tax planning with intercompany interest deductions dates back at least 30 years in Sweden, it was not until 2009[3] that it was considered such a serious threat to the tax base that Sweden introduced legislation to prevent it.[4] These provisions were introduced when tax audits on Swedish multinational enterprises indicated an annual base erosion of approximately SEK 25 billion.[5] Two additional investigations by the Tax Agency revealed inefficiency in the 2009 limitation rules, resulting in the launch of second-generation limitation rules on interest deductions in 2013.[6]

Since first introduced in 2009, the anti-avoidance rules have been heavily criticised for their vagueness, and even for being in conflict with the the Treaty on the Functioning of the European Union.[7] Consequently, the Swedish Committee on Corporate Taxation (*Företagsskattekommittén*) was given the assignment of presenting new regulations that could replace the criticised rules. In June 2014, the Committee proposed a new corporate income tax system that involved extensive limitation rules on interest deductions.[8]

Outside Sweden, *base erosion and profit shifting (BEPS)*—the process of moving profits to a lower-tax jurisdiction—have been addressed by the Organisation of Economic Co-operation and Development (OECD) and the European Commission. In these high-profile projects, the main purpose of which is to facilitate the drafting of tax law that makes it possible for member countries to tax income generated within their borders, anti-avoidance rules on companies' interest deductions are essential.[9]

In national and international efforts to find methods that make it possible to tax production where it is conducted, the focus is on corporate income taxation. The theoretical basis for such new tax models as the comprehensive business income tax (CBIT) and allowance for corporate equity (ACE) are based predominantly on economic research focusing on the way different tax rules affect the behaviour of multinational enterprises.[10] New models to meet the challenges of base erosion and profit shifting involve equal treatment of debt and equity to the highest possible extent. According to relevant theory, such treatment will make the corporate income tax systems more effective, compared to a situation in which debt and equity are treated differently.[11]

The theories encouraging equal treatment of debt and equity are far from new—a noteworthy fact in the OECD's ongoing BEPS project. The most fundamental of

[3] Prop. 2008/09:65.

[4] Hilling, A 2012 p. 313–315.

[5] Swedish Tax Agency, 2008.

[6] Swedish Tax Agency, 2009 and 2011; Prop. 2012/13:1. See also Swedish Tax Agency, 2014.

[7] See Section 5.3.1.

[8] SOU 2014:40. For a presentation of the proposal, see Lodin, 2014.

[9] OECD, 2013a/b and COM, 2012, 722 final.

[10] See especially Auerbach et al., 2010 and de Mooij & Devereux, 2011. The dominance of economic literature, in relation to legal ditto, is conspicuous in the proposal of the Swedish Committee on Corporate Taxation, see SOU 2014:40, pp. 85–120.

[11] de Mooij, 2011, pp. 9–12.

these principles can be traced back many decades.[12] Thus the financial/economic theories on which new tax systems are founded are generally much older than most tax systems, such as the Swedish system of 1990, which are now subject to major makeovers. This idiosyncrasy raises the following question: why did the tax legislators not rely on these theories when today's tax system was designed? More specifically, why did the tax legislators not treat debt and equity alike when designing the tax systems that are now being overhauled?

When the current Swedish income tax system was designed, the corporate income tax system was expressly perceived as an integrated part of the taxation of individual earnings from capital investments.[13] Consequently, the perspective of the system differed from the current one, focusing as it did on the taxation of company owners rather than companies. Goals for effective corporate income taxation thus had to be balanced against other goals of the income tax system—for example, equal taxation of individuals.

As for the Swedish taxation of income from capital, the preparatory works to the 1990 tax reform required horizontal equity: not only should capital income be taxed the same as income from labour but equal tax should apply to the various types of capital income.[14] The principle of horizontal equity had a strong status at the time the income tax system was drafted and has seriously influenced the structure of the system.[15] As a result, Swedish corporate income taxation was initially structured as an integrated part of the entire income tax system, the overall goal of which was to tax income equally at the individual level.

Because of the foundation of today's tax system in the principle of horizontal equity and because corporate income taxation is structured as an integrated part of a system, tax legislators' arguments in favour of new corporate income taxation are open to criticism. Treating corporate income taxation in isolation from the rest of the tax system clearly challenges the objective of horizontal equity, which is a fundamental element of the system and triggers the question of whether tax legislators now find it more important to support effective corporate income taxation than to support equal income taxation for individuals. It also triggers the question of whether it is possible to maintain equal taxation and still defend the corporate tax base from international tax planning.

We have found no evidence that the Swedish tax legislators have announced a shift in preference of their tax law policy from equal taxation to effective corporate income taxation. Furthermore, debt and equity financing and multinational enterprises existed prior 1990, and were apparently not considered an insoluble obstacle for equal taxation when the 1990 tax system was constructed. Consequently, there must be another reason for shifting the focus from equal to effective taxation.

We argue in this article that it is the tax legislators' inability to classify new financial instrument as debt or equity properly that has forced them to abandon equal taxation. More specifically, it is the legal distinction between debt instruments and derivative instruments that constitutes the seemingly irresolvable classification issue.

[12] See Seligman, 1925, pp. 271–315; Modigliani & Miller, 1958.

[13] SOU 1989:34, part I, pp. 207–215, and Prop. 1989/90:110, pp. 514–519.

[14] Prop. 1989/90:110, pp. 296, 304–305, 388 and SOU 1989:33, part I pp. 60–72.

[15] SOU 1989:33, part I pp. 49–56. About horizontal equity, see Holmes, 2001, pp. 19–21.

1.2 Purpose

The legal distinction between debt and equity has been subject to extensive doctrinal discussions in Europe and North America.[16] In most cases, the international challenge—the challenge for open economies to collect revenue in a globalised world—forms the basis for the discussion.[17] Thus, much of the discussion focuses on the impact on corporate behaviour (efficiency and neutrality) of different solutions for classifying debt and equity and/or how these solutions relate to states' tax revenues.[18] Accordingly, the theoretical basis is primarily financial theory and theories of public economy.[19] Knowing, however, that a fundamental basis for all tax systems is that the taxpayer—eventually the individuals within the taxing jurisdiction—perceives the tax system as fair, we consider equal taxation merely as a relevant basis for evaluating legal classification within a tax system.[20] Thus, this article takes a somewhat different perspective on a subject that has already been heavily debated. Its explicit purpose is to present tax equality (horizontal equity) as a reason for treating income from debt and equity differently, and to demonstrate how the general trend in corporate income taxation (treating debt and equity alike) challenges horizontal equity. We use the Swedish income tax system in our presentation, illustrating its development from equal income taxation to unequal but (deemed) effective corporate income taxation.

1.3 The Swedish tax system—an overview

The Swedish income tax system differs from most other income tax systems as it is a dual income tax system. The content of this difference is presented in more detail in sections four and five below. To facilitate a general understanding of this system, however, and thus make the article easier to follow right from the beginning, this section provides a very short overview of relevant parts of the system, and how they relate to the general problems dealt with in the article.

The Swedish dual income tax system taxes personal income through two separate income tax schedules: capital income and wages. Capital income is taxed at a flat rate while wages are taxed at a progressive rate. The flat tax on income from all kinds of different assets is a challenge in terms of horizontal equity in taxation of real capital income. The effective tax on the real income from a capital investment will differ according to the investment's appreciation in value over time—its risk. Assets with a greater appreciation over time will be subject to a lower effective income tax on the real income when compared to assets with a low appreciation over time. In order to deal with this challenge, and thus maintain horizontal equity, financial instruments with a potential for great appreciation over time—equity instruments—are subject to economic double taxation whereas financial instruments with limited potential for value appreciation over time—debt—are not.

This article focuses on this risk-based taxation of debt and equity, and how hybrid financial instruments can be used to circumvent the system by exploiting weaknesses in the legal classification of these instruments. The use of hybrid instruments results

[16] See Pratt, 2000; Schoen, 2009; Brown, 2012; Marres & Weber, 2012.

[17] See Bundgaard, 2014; Eberhartinger & Six 2009. See also Folkvord & Riis Jacobsen, 2014 regarding the international challenge and its impact on the Nordic countries.

[18] See Bärsch, 2012, pp. 44–52; Marres & Weber, 2012.

[19] See generally Blessing, 2012.

[20] See Avi-Yonah, 2006; Alley & Bentley, 2005.

in the avoidance of economic double taxation on income from assets with potential for significant appreciation over time, and is thus an effective tax on the real income from these instruments that is substantially lower than the effective tax on income from assets with the same financial risk.

1.4 Outline

The remainder of this article is organised in three parts, the first of which—Section 2: *Taxing financial instruments* and Section 3: *Distinguishing between debt and derivatives*—presents the general structure of the Swedish tax system and the basics of financial engineering. The purpose of these sections is to present the conditions which have eventually motivated the Swedish tax law maker to abandon equal taxation. The second part of the article—Section 4: *Taxation of capital income* and Section 5: *The problem and how it is handled*—presents legal developments within the relevant areas, why these developments were found to be unsatisfactory, and how they were dealt with in new legislation. Section 6: *Unequal taxation* and Section 7: *Conclusions* illustrate the effects that the new regulations have had, and will have, on capital taxation, as well as the extent to which these effects are in accordance with the fundamental principle of equal taxation. Finally, this section summarises the article and offers some concluding remarks.

2. TAXING FINANCIAL INSTRUMENTS

2.1 General characteristics

Our key conclusion is that derivatives cause insoluble classification issues that severely challenge the traditional tax system, in which the treatment of financial instruments is based on their legal form.[21] Knowing that derivatives and other financial instruments are often perceived as a relatively challenging area within tax law, the following sections present some general information on the characteristics of derivatives and other financial instruments, and how they generate income.

2.2 Derivatives

Throughout this article, we refer to plain vanilla derivatives, forwards and options, which are explained in greater detail in Section 3.2. At this point, however, it is worth noting that *derivatives are financial instruments that provide returns directly related to the returns of the instrument that underlies them*—for example, corporate stock. There is a difference between investing in a corporate stock and investing in its derivative: the derivative investment demands less capital, yet the possible return can be the same. Thus, in relation to an investment in corporate stock, an equity derivative provides a much higher return and is often referred to as a *leveraged instrument*.

[21] See Section 7.

2.3 Three subcategories of financial instruments

A *financial instrument* can broadly be defined as:

> any evidence of the legal relationship arising from the provision of money, property, or a promise to pay money or property by one person to another in consideration for a promise by the other person to provide money or property at some future time or times, or upon the occurrence or non-occurrence of some future event or events.[22]

In Swedish income taxation, it has been found necessary to divide these instruments into at least three subcategories: *debt, equity,* and *derivatives on assets other than debt and equity*. In the corporate income taxation system, the distinction between debt and derivatives has been of limited importance because the returns from either kind are treated alike. Because the return from equity is treated differently, however, the distinction between debt and equity has been a major issue in corporate income taxation. Furthermore, because debt is treated favourably to equity and to derivatives on other assets when held by individuals, Swedish taxation of individual capital income includes classification issues between debt and equity and between debt and derivatives.

2.4 Return from financial instruments

2.4.1 Two kinds of income

In analysing the income taxation of financial instruments, it is important to understand that these instruments provide two types of income: *income from production* and *windfall gains (speculation income)*. The holder of a financial instrument may, in many situations, choose whether the income shall be distributed as current income or as capital gains. Thus, the following sections briefly outline the general differences between these two types of income and how it may be distributed.

2.4.2 Income from production

The extensive concept of income used in Swedish income taxation includes income from production and from windfall gains.[23] Income from production generally equals Sweden's net domestic product (NDP), which leads to the conclusion that NDP never exceeds the investor's total income. This conclusion is challenged, however, if those who invested in Swedish production have large debts to, or claims in, foreign countries. In cases where investors have large debts to foreign countries, their net income will be reduced, and will therefore become smaller than their production output.[24] If an investor has large claims in foreign countries, the opposite occurs.

If capital is invested in production, the return from the investment will be distributed as interest, dividends or capital gains. The legal contents of these concepts are further discussed in Section 4. In order to facilitate the understanding of these legal concepts, however, it is necessary to stress that a capital investor may, in many situations, be able to choose whether the value of the production is distributed as dividends and/or

[22] Edgar, 2000, pp. 4–5.

[23] The concept of income generally corresponds to what is commonly referred to as the Schanz-Haig-Simons concept of income; see for example Holmes, 2001, pp. 55–57.

[24] Within income taxation, this is generally referred to as *base erosion*.

interest or even as capital gains. If the owner of a company decides that no dividends shall be paid, the value of the owner's shares will increase correspondingly with the value of the forgone dividends and will be distributed as capital gains when the shares are disposed of. Equally, if the holder of a bond disposes of it before maturity, the bond holder's capital gain will correspond with the value of accrued interest. It is therefore necessary to treat current income and capital gains and losses from the same kind of financial instruments equally in the tax legislation in order to avoid *tax arbitrages: profiting from tax shelters or differences in the way income or capital gains are taxed*.[25]

2.4.3 Income from speculation—windfall gains

As mentioned in the previous section, Swedish income taxation does not merely cover income from production, it also taxes several kinds of windfall gains. The main difference between these two kinds of income is that income from production equals the value added in society, whereas a windfall gain is income that does not correspond to any value added in society. Thus, a windfall gain always corresponds to a windfall loss. A *forward contract*—whereby one party agrees to buy and another agrees to sell an asset in the future to a price agreed upon today—is a typical example of a capital investment that results in windfall gains and losses. Such a derivative contract has no initial value and eventually involves one of the contracting parties paying money to the other party without getting anything in return. Thus, it is a zero-sum game, resulting in no value added to society. Just like gains from investments in production, however, windfall gains on financial instruments are classified as capital gains in Swedish income taxation.

2.5 Financial income

From what has been argued in Section 2.4, it is possible to conclude that financial income—interest, dividends and capital gains—is the sum of a tax subject's return from capital investments in production and windfall gains. Because it is possible to speculate about the success of future production in a company, the return from equity derivatives and the actual equity instrument—the underlying corporate stock—are related. This means that it is possible to replicate the return from a company stock (production) by the use of derivatives (speculation).[26] Consequently, it is rational, in terms of income tax equality, to treat the return from derivatives equally to the return of underlying assets.[27]

We argue that financial instruments that typically produce windfall gains and losses (derivatives) can be merged with financial instruments that typically produce income from production (equity and debt). Because, in many situations, the investor in equity and debt can choose if the return from the investment is distributed as capital gains or interest/dividends (see Section 2.4.2), situations may occur in which the periodic return from debt (interest) is, in substance, a windfall gain. It is the failure to take this

[25] For example, the Swedish income exemption on dividends from substantial holdings applies also to capital gains and losses on those holdings; Ch. 24 and 25a ITA.

[26] See Section 3.3.

[27] See, for example, Hilling, 2007, pp. 82–83.

transformation properly into account that really makes a mess of capital income taxation.[28]

2.6 A risk-based tax system aimed at horizontal equity among sources of personal income

In Section 4, we present the purpose of today's tax system. Before that analysis, however, we comment on the structure of the system in order to explain the perspective of the tax legislator, particularly how they view the characteristics for certain capital investments: debt and equity.

A general purpose of the Swedish income tax reform of 1990 was to create horizontal equity for produced income—among different types of capital income and income from labour.[29] This aim indicates that the tax system is based on the assumption that personal income is the relevant perspective, making corporate income taxation an integrated part of personal income taxation rather than an autonomous tax system.

When the Swedish income tax system was launched in the early 1990s, the effective tax rate on income from labour was, for the majority of Swedish labourers, approximately 60%, including payroll tax. To achieve horizontal equity in the taxation of income from labour and real capital income, Sweden uses a classical system. Table 1 shows how the tax system is constructed to achieve horizontal equity between real income from debt and equity:

Table 1: Equal taxation of real income from debt and equity[30]

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	4.00%	1.96%	61.20%

Note: In order to target the effective tax rate of wages at approximately 60%, dividends are subject to double taxation and interest is not. Relevant tax rates from 1990 are used in this table. Source: authors.

Table 1 illustrates that the design of the tax system is based on the assumption that debt is an investment that generally provides lower return than equity. It also shows that interest is assumed to be a return that does not greatly exceed inflation. Under these circumstances—a risk-based tax system—the taxation of capital investments adheres to the goals of horizontal equity.[31] It is noteworthy that the structure of the tax system is based on the assumption that equal taxation can only be fulfilled if debt and equity are treated differently. Consequently, their altered characteristics in regard to financial risk must have been considered, by the legislator, to be too great to meet the general purpose of horizontal equity without treating debt and equity differently.

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[28] See Section 5.

[29] See Section 4.1

[30] The components in the columns has been calculated as follow: **Effective tax**: 1*30% [CIT] + (1-(1*30% [CIT]))*30% [Tax on capital income]; **Real Income**: (1+12% [Nominal Income]) / (1+2% [Inflation])-1; **Tax on real Income**: (100*12% [Nominal Income] * 51% [Effective tax]) / (100*9.8% [Real Income]). The figures in the columns **Corporate Income Tax**, **Inflation** and **Nominal Income** are picked to illustrate the estimations on which the legislation was designed.

[31] For a discussion about taxation with a risk-based classification of debt and equity see Ceryak, 1990 and Politio, 1998.

2.7 Summary

Taxable income can be divided into income from production and windfall gains (speculation income). Capital income from production is classified as dividends, interest or capital gains. Capital income from windfall gains is classified as capital gains. This makes it possible to conclude that a capital gain may result from an investment in production or speculation, but that dividends and interest always represent income from production. In the next section, however, we argue that, in many situations, it can be difficult to define whether a capital investment is, in substance, an investment in production (debt) or an investment in speculation (derivative). An unsuccessful classification may lead to the return from an investment in production (debt), being treated in substance as a return from an investment in speculation (derivative), although the return is legally classified as interest when distributed to the investor. Because the structure of the tax system requires debt to be a financial instrument with low risk, classifying speculative activities as debt may severely challenge the functioning of the tax system.

3. DISTINGUISHING BETWEEN DEBT AND DERIVATIVES

3.1 Financial engineering

Financial engineering may be generally defined as the development and creative application of innovative financial technology.[32] The decade before the financial crisis in 2008 saw massive growth in financial engineering, heavily increasing the pace and complexity in the development of new financial products. Consequently, the financial landscape is fundamentally different today compared to the time when the current income tax system was designed and drafted. In this section, we illustrate how basic financial engineering challenges the concepts of debt and equity, as perceived in the income tax system. In particular, financial engineering challenges the conception that debt is always a financial instrument with low financial risk.

3.2 Arbitrage and replication

3.2.1 No arbitrage assumption

The basis for financial engineering is a relatively straightforward exercise: *asset pricing.* The price of any financial asset is the discounted future cash flows of that asset, which implies that the discount rate and the required rate of return are the same. This is true for stocks, bonds, options, credit default swaps and all other securities. It is difficult, however, to find the correct future cash flows and the correct discount rate. Asset pricing is primarily concerned with finding discount rates, whereas forecasting future cash flows for a company, for example, is the domain of analysts.

A standard assumption in asset pricing is the *principle of no arbitrage*, where arbitrage is 'a portfolio that guarantees net cash inflows without any net cash outflows'.[33] From the no-arbitrage assumption, it follows that assets with identical cash flows must have identical prices. This idea is used extensively when pricing derivatives through *replication*: finding assets or portfolios of assets with known prices that have exactly

[32] Beder, 2011, p. 3.

[33] Sundaram & Das, 2011, p. 60.

the same cash flows as an asset with an unknown price. Thus, from the no-arbitrage principle, the asset with an unknown price must have the same price as the portfolio that replicates its cash flows.

3.2.2 Bonds

For some instruments, such as bonds, the future cash flows are known at the time of purchase. When the cash flows are known and a market price is observed, the discount factor, which is also called the expected or required return of the asset, can be directly calculated without any model assumptions. Using a simple example, we take a zero-coupon bond with exactly one year to maturity with a nominal value of N. The price (P) is observable if the bond is traded on a market and theoretically given by:

$$P = \frac{N}{1+y}$$

where *y* is the required rate of return on the bond. To get the discount rate, we use the fact that P and N are known, and solve for *y*. Thus, we get

$$y = \frac{N}{P} - 1$$

When the time to maturity differs from one year or when the bond has coupon payments, the mathematics are more complicated, although the principle is the same. So the required rate of return can be inferred for any traded bond.

3.2.3 Forwards

To expand upon a previous definition, a forward contract is an obligation for one party to buy and for another party to sell an asset (the spot asset) to a price agreed upon today, called the forward price. The spot asset is delivered at an agreed-upon future date called the maturity date.

The forward price is set so that the contract has a price of zero; no cash flows are exchanged between the buyer and the seller at the contract date. At the delivery date, the seller delivers the product and the buyer pays the forward price. This is how a forward contract can be replicated by the spot asset and a zero-coupon bond.[34]

Holding a forward contract will provide one unit of the underlying asset at the time of maturity. To replicate this holding, one can simply buy the spot asset instead and hold it until maturity. Because both these transactions provide the same asset, both must have the same cost. The cost of buying the spot asset using the forward contract is the forward price (F), which is paid at delivery, so the price today is the present value of the forward price, which we denote PV(F). The cost of buying the spot asset is the current spot price today, plus such other possible costs as storage and insurance, depending on the nature of the spot asset. (For simplicity's sake, we ignore these extra costs here.) By setting the costs equal, we must then have $PV(F) = S$ or expressed differently, $F = S(1 + r)$ with r being the discount rate. Following is an example of creating an arbitrage profit when the relationship described in this paragraph is not true.

[34] Sundaram & Das, 2011, pp. 61–62.

Example: Assume that the spot price of gold is $300, the forward price is $311 for delivery of gold one year from now, and the rate of interest is 2%. The theoretical spot price should then be $300(1 + 0.02) = 306$. Because the market price of the forward contract is too high, we sell the forward contract and buy the spot asset today, which requires us to borrow $300 at an interest rate of 2%. After one year, we deliver the spot asset and get our $311. Repaying our loan with interest will cost us 1.02 x $300 = $306, resulting in a riskless profit of $5.

Note that in order to replicate a short position in a forward contract, one must borrow money (sell a zero-coupon bond). To replicate a long position in a forward contract, one must deposit money (buy a zero-coupon bond), which means that any forward contract can be seen as a combination of the spot asset and a zero-coupon bond.

3.2.4 Options

A European call option gives the buyer of the contract the option to buy the spot asset (the underlying asset) at a pre-specified price, called the strike or exercise price (X), at a pre-specified future date (T), called the maturity date. The seller of the call option contract has a binding obligation to sell the spot asset if the buyer chooses to use the option. An American call option can be used at any time at or before the maturity date. (The terms 'European' and 'American' do not refer to the location where the contracts are geographically traded.) A put option gives the buyer the right to sell the spot asset, and consequently the seller of the put option has the obligation to buy the spot asset.

An option can be replicated by owning (or selling short) a fraction of the underlying asset, while simultaneously having a short or long position in a bond (borrowing or lending money). To replicate one call option, for example, one must own less than one unit of the spot asset and borrow some money. The call option is therefore equivalent to a leveraged position in the spot asset. The exact quantities—the fractional quantity of the spot asset owned—can be calculated if one is willing to assume a particular option-pricing model; the quantities will depend on the relationship between the spot price and the strike price and on the volatility of the spot asset.

We now introduce the option-pricing model that is still, after 40 years, the one most widely used: the Black and Scholes option pricing model,[35] which gives the price of a call option C as:

$$C = S \cdot N(d_1) - X \cdot N(d_2)e^{-r(T-t)}$$

where $d_1 = \frac{\ln\left(\frac{S}{X}\right)+(r+0.5\sigma^2)(T-t)}{\sigma\sqrt{T-t}}$ and $d_2 = d_1 - \sigma\sqrt{T-t}$. S is the price of the spot asset, N is the cumulative distribution function of the standard normal distribution, X is the exercise or strike price, e is the mathematical constant $e \approx 2.72$, r is the risk-free rate of return, T-t is the time to maturity of the option, and σ^2 is the return variance of the spot asset. All quantities are expressed on a yearly basis. The interpretation of $N(d_1)$ and $N(d_2)$ is, loosely speaking, the probability that the option will be exercised at maturity.

[35] The model was developed in Black & Scholes, 1973 and Merton, 1971.

The mathematics may look uninviting, but the intuition behind the formula is straightforward. The formula simply states that the price of the call option is equal to what one would expect to get (the spot asset with probability $N(d_1)$) minus the present value of what one would expect to pay ($X \cdot N(d_2)$).

Because the moneyness of an option measures the probability that the option will be exercised, moneyness increases for a call option when S/X increases. Because X is fixed for a given option contract, moneyness increases when S increases—when the spot asset increases in value. An option with high moneyness (S>X for call and S<X for a put) is said to be in the money, when S is much larger than X (smaller for a put) the option is said to be deep in the money. A deep-in-the-money option behaves more and more like a spot asset; when the spot price tends to infinity, a call option behaves like the spot asset. We show this formally by calculating the call option price, C, in the limit when S tends to infinity:

$$\lim_{S\to\infty} S \cdot N\left(\frac{\ln\left(\frac{S}{X}\right) + (r + 0.5\sigma^2)(T-t)}{\sigma\sqrt{T-t}}\right) - X \cdot N\left(d_1 - \sigma\sqrt{T-t}\right)e^{-r(T-t)}$$
$$= S \cdot N(\ln(\infty)) - X \cdot N(\infty)e^{-r(T-t)} = S - Xe^{-r(T-t)} \approx S$$

The second equality follows from using $\lim_{x\to\infty} N(x) = 1$, and the approximate equality follows—simply because S is much larger than X.

3.3 Hybrid instruments

3.3.1 Legal classification

To this point we have illustrated that the return from derivatives—forwards and options—can be fully replicated by means of a bond and (a fraction of) the underlying of the derivative. From an income tax point of view, this means that it is possible to replicate a derivative on a company stock by means of financial instruments with the legal classification of debt (a bond) and equity (stock). Thus, when it comes to returns—income—an equity derivative is a hybrid between debt and equity.[36] Because the tax treatment of debt and equity differ, the hybrid character presents a potential classification problem. To solve this problem, it seems necessary to find a way to distinguish between the debt part and the derivative part of the hybrid contracts. *To tear a financial instrument into its component parts and treat them as building blocks is generally referred to as bifurcation*. Bifurcation is not an option, however, because like most other tax systems, the Swedish income tax system treats financial instruments as indivisible contracts when classified as debt or equity.[37] Thus, the *hybrid instrument must be classified as either an equity derivative or a debt—a classification generally referred to as the all-or-nothing approach.*[38]

The classification of a financial instrument as debt or derivative will be relatively challenging in many situations, however, because the character of the derivative is

[36] In addition to the meaning of the term hybrid instrument, as used in this article, the term is sometimes also used to describe financial instruments that are classified as debt in one country but as equity in another, or as debt at one time, but as equity at a later occasion. We do not refer to hybrid instruments in the latter sense.

[37] RÅ 1994 ref. 26.

[38] See generally Madison, 1986.

continuously shifting in proportion to the instruments it replicates: a bond and the underlying. Thus to classify a financial instrument as debt or a derivative of a certain underlying may be an impractical exercise, as illustrated in the next sections.

3.3.2 The shifting character of an option

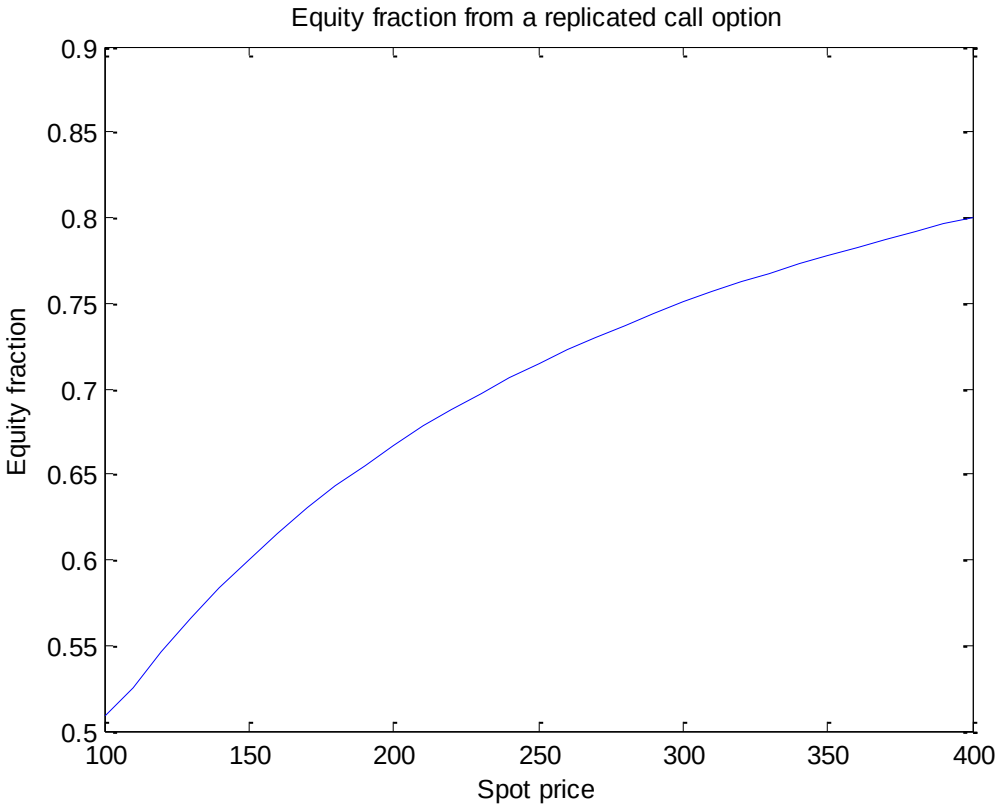
In Section 3.2.4, we illustrate that the return from an option can be replicated by a bond and a fraction of the underlying. An option in equity is thus a replica of what is legally classified as debt and equity. To calculate the debt fraction of an option, we can again use the Black and Scholes model, which shows that a call option is replicated by $C = S\Delta_c - B_c$ where $\Delta_c = \mathrm{N}(\mathrm{d}_1)$ and $B_c = \mathrm{X} \cdot \mathrm{N}(\mathrm{d}_2)\mathrm{e}^{-\mathrm{r}(\mathrm{T}-\mathrm{t})}$. The interpretation is that B_c, the amount of money one must borrow and $S\Delta_c$ that provides the fraction of the spot asset to buy (Δ_c is never larger than one). If we assume that the underlying asset is a stock, we can then see that an option is a combination of debt and equity, and the proportion that is equity depends on the moneyness of the option through $\mathrm{N}(\mathrm{d}_1)$ and $\mathrm{N}(\mathrm{d}_2)$. As calculated above, for a very deep in-the-money call option, we get $\mathrm{N}(\mathrm{d}_1) = \mathrm{N}(\mathrm{d}_2)$=1. So we get:

$$C = S - \mathrm{X}\mathrm{e}^{-\mathrm{r}(\mathrm{T}-\mathrm{t})}$$

The option is equal to the stock value plus borrowing the present value of the strike price, so in this case the option is almost pure equity. We define the commodity fraction to be $S\Delta_c/C$ and calculate the equity fraction for a hypothetical call option with a volatility of 15%, a time to maturity of 1 month, a risk-free rate of interest of 2%, an exercise price of $100 and a spot price ranging from $100 to $400.[39] The equity fraction ranges from 50.8% to 80.0%, and by using ever-higher spot prices, the fraction would eventually approach 100%. Note that this result not only reveals that different option contracts can have very different equity/debt proportions, but that the same option contract can have vastly different equity/debt proportions over time, due to changes in the price of the underlying asset.

[39] The results are not sensitive to the choice of volatility, risk-free rate and time to maturity.

Figure 1: Equity fraction form a replicated call option



Note: This figure shows the equity fraction from a call option replicated by the spot asset and a bond.
Source: authors.

3.3.3 Prepaid forwards

A prepaid forward contract is identical to a forward contract, with the single difference that the forward price is paid when the agreement is entered upon and not when the spot asset is delivered.[40] This difference creates slight changes to the replication strategy. The cost of buying the spot asset using the forward contract is still the forward price (F), which is paid at today's price, so the price today changes from PV(F) to simply F. If we once again ignore costs of storage, insurance and possible dividends, the prepaid forward price is simply equal to the spot price F = S, because the cost of buying the spot asset on the spot market and using the prepaid forward contract is the same. If we add storage costs (m) expressed as a fraction of the spot price, we get F = S(1+m), and there is now a difference between the prepaid forward price and the spot price. When we use the prepaid forward contract rather than buying the asset on the spot market, we avoid paying storage costs.

We now know that a prepaid forward price is identical to the price of the underlying asset: F = S. We also know, however, that it is possible to replicate the underlying (asset) by a portfolio with a regular forward contract and a bond.[41] Consequently, a

[40] See Section 3.2.3.

[41] See Section 3.2.3.

prepaid forward contract is, in substance, a portfolio with a regular forward contract and a bond. Because financial instruments are generally treated as indivisible contracts, a possible solution is to classify these contracts as derivatives, thereby dealing with tax arbitrage possibilities.[42]

The other possible way of dealing with prepaid forward contracts for income tax purposes is to classify them as debt instruments, because of the initially large debt fraction in the contract. This line of reasoning opens up possibilities for creating extremely risky debt instruments. If a prepaid forward contract with equity as an underlying is classified as debt, for example, the debt instrument will have the same financial risk as the underlying asset. Consequently, prepaid forward contracts may facilitate the taxpayer's ability to invest in a certain asset by a direct purchase of the asset, or through the use of a debt instrument. When the underlying is corporate assets (equity), it may be advantageous for the taxpayer to make the investment by a prepaid forward contract—a debt.[43]

3.4 Ever-changing characteristics

We have now illustrated how options and forwards work, and how they can be used to replicate a portfolio with a bond and the underlying derivative. As the moneyness of the derivative increases, the equity fraction of the derivative also increases, at the expense of the size of the derivative's debt fraction. For the issuer of such a derivative the opposite occurs. Consequently, the issuance of deep-in-the-money options and prepaid forward contracts, have many characteristics similar to the issuance of ordinary debt instruments. Unlike ordinary debt instruments, however, the debt characteristics of a derivative may decrease or even disappear over the duration of the instrument. Because of the ever-changing characteristics of derivatives in relation to the legal definitions of the instrument in its replica portfolio, the classification of financial instruments as debt or derivatives will always be uncertain.

Fixing the time at which a financial instrument shall be legally classified as debt or a derivative is a standard way of dealing with uncertainty caused by the shifting character of hybrid financial instruments.[44] Swedish case law has determined the relevant time to be the point at which the instrument is issued.[45] In principle, this fixed-time approach increases legal certainty, which is good, but does not deal with the actual problem caused by hybrid financial instruments: high-risk debt instruments. In fact, it can be argued that using the time at which it is issued as the basis for classifying a financial instrument creates the possibility that high-risk derivatives can be classified as debt instruments as long as they are issued deep in the money.

Bifurcation has been described in the literature as the most effective way of dealing with income-tax problems of high-risk debt instruments—hybrids.[46] As mentioned previously, however, bifurcation—treating the financial building blocks of a financial instrument separately for tax purposes—is not an option in Swedish income taxation

[42] Such treatment can be criticized because the relatively large debt fraction of the contract is treated differently from regular debt, see Edgar, 2000, 246–sequent.

[43] See Section 4.3.

[44] See Polito, 1998, pp. 803–805.

[45] RÅ 2008 ref. 3.

[46] See e.g. Madison, 1986; Politio, 1998; Edgar, 2000; Hilling, A, 2007.

because the Supreme Administrative Court (SAC) has identified its opposite, the 'all-or-nothing' approach, as the prevailing rule.[47]

3.5 Summary

In this section, we have explained that derivatives with large moneyness are similar to ordinary debt instruments. It may be challenging, therefore, to find ways to distinguish legally between debt and certain derivative contracts—hybrid instruments. As a result, when hybrid instruments (derivatives with large moneyness) are legally classified as debt instruments, the perception of debt as low-risk financial instruments is severely challenged. Tax systems, Sweden's included, which have preferential treatment for debt income, expose themselves to serious tax-arbitrage schemes, such as tax planning with inter-company interest deductions.

In the next section we illustrate how this 'insoluble' classification issue challenged the Swedish income tax system and how the traditional classifications of financial instruments as debt and equity were eventually abandoned.

4. TAXATION OF CAPITAL INCOME

4.1 Purpose of the law

4.1.1 Preparatory works

In this section, we briefly present the purpose of the relevant tax law, based on what is set out in relevant legal preparatory works. The Swedish tradition of extensive preparation of legislation involves several types of preparatory works.[48] For interpretation of tax law, the key types are government bills (*propositioner, Prop.*) and Ministry of Finance Committee Reports (*Statens offentliga utredningar, SOU*).

4.1.2 Equal taxation

With direct reference to the ability-to-pay principle and the constitutional principle of equality, an explicit purpose of the Swedish tax reform of 1990 was to attain equal taxation: 'that persons with equal income, wealth etcetera are taxed alike'.[49] In the context of a dual-income tax system, which was introduced in Sweden by this tax reform, it was decided that any return from any type of asset was to be taxed equally in the income tax schedule—capital income.[50] This is generally referred to as a flat-rate tax on capital income, but must not be mistaken for the flat tax on savings and investments, which is described in Section 5.2.1.[51] Theoretically the flat tax on capital income involves a relatively complex taxation of income on an accrual basis.[52] For reasons of simplicity and taxpayers' ability to pay, however, accrual taxation was dismissed in favour of the cash basis and the realisation principle (revenue can be

[47] See Section 3.3.1.

[48] For a discussion of the different kinds of preparatory works, see, for example, Melz, 2007, p. 137.

[49] SOU 1989:33 part I, p. 52, see also Prop. 1989/90.:110, part I, p. 388. This and all other translations from Swedish to English have been done by the authors.

[50] SOU 1989:33 part I, p. 63–64, SOU 1989:33 part II, p. 14.

[51] See Birch Sorensen, 1994.

[52] SOU 1989:33 part I, pp. 56–57. About accrual taxation, see Shakow, 1986.

recognised only after the goods or services have been delivered).[53] As a result, current investment income, such as interest and dividends, is taxed in the same period that the taxpayer has access to the return. Other returns—capital gains and losses—are taxed when the asset is disposed of.

In summary, the equality, certainty and simplicity of the legislation is satisfied when all returns on capital—current income as well as capital gains and losses—are taxed in the same income tax schedule and in the same way, independent of the type of income-generating asset. Equality does give way to certainty and simplicity, however, when accrual income recognition is dismissed in favour of cash basis and realisation. The primary inequality this deviation may create is that the real income classified as capital gains will be reduced over time due to inflation, and may therefore be taxed somewhat higher than interest and dividends because of the nominal calculation of taxable income.[54] In relation to investments in financial assets, this is really not a big issue, particularly because inflation has been relatively moderate since the launch of the relevant tax legislation.

4.1.3 Limitation of potential, unwanted tax credits

Although the use of a different principle for the periodisation of income does not severely challenge equal taxation of the positive return from financial investments, the use of the realisation principle causes some difficulties. This situation exists because the realisation principle facilitates the creation of tax credits, which would have been impossible through consistently applied accrual income recognition.[55] A tax credit[56] is, in effect, an interest-free loan from the government to the taxpayer, and it typically occurs when a taxpayer knowingly brings forward the realisation of a loss position and pushes the realisation of gain positions into the future.[57] Because the possibility of generating tax credits is clearly in conflict with a goal of equal taxation, measures have been taken to limit the taxpayer's ability to enhance such credits. These measures have taken the form of general deduction limitations of 70% of capital losses. Deduction limitations for capital losses are, however, significant exceptions to the goal of equal treatment of current returns and capital gains and losses within the income tax schedule, Capital Income. This is so because interest expenses are usually fully deductible against any kind of capital income, as further explained in next section.

4.1.4 Interest expenses favored to capital losses

Deductibility for interest expenses is not limited the same way that capital losses are, a situation motivated primarily by housing policy. It was decided that interest expenses on private homes should be fully deductible against wages. Because the dual income tax system treats capital income and income from labour separately, however, the

[53] SOU 1989:33 part II, pp. 32–37, Prop. 1989/90:110, part I, p. 396–399.

[54] In addition there are also the benefits in the continuous compounding of the capital in long term investments. On the down side is the lock in-effects related to realisation taxation of capital investments.

[55] Shakow, 1986, p. 1117.

[56] The term tax credit must not be mistaken for the same term used in international taxation. While a foreign tax credit (see e.g. Article 23B OECD MC) provides credits equal to taxes paid in foreign states, the tax credits we refer to in this article provide credits equal to losses realised for the primary purpose of deferring the taxation of capital income.

[57] SOU 1989:33 part II, p. 41. See also Hilling, A. (2007) pp. 56–57.

technical solution is a tax credit of 30% of the deficit in the income schedule capital, which is fully deductible against wages, with an effective tax rate of 30%.[58] The difference in the deductibility of capital losses and interest expenses were not entirely consistent, however. Capital losses on interest-paying financial instruments are treated as interest; there is no restriction or quota on interest cost deductions for those instruments as there are for other types of capital losses. This inconsistency exists partly to avoid demarcation problems in classifying returns as interest or as capital gains or losses. Furthermore, it was considered that a deduction limitation for these capital losses would be unduly restrictive, because potential tax credits would still be relatively small with respect to the limited durations and moderate rate variations of these instruments.[59] For control reasons, only publicly traded instruments were exempted from quota. Here again, it becomes evident that the tax-law maker contemplated debt a financial instrument with low risk.[60]

4.1.5 Effective taxation of corporate investments

Finally, the tax reform of 1990 highlights the need for effective tax legislation regarding investment in corporations. A general purpose of the legislation was therefore to ensure that it would never be more advantageous to invest in a corporation by means other than an ordinary corporate share. Thus, any investment for which the return is connected in one way or another to the return of a corporation is to be treated for tax purposes as equal to corporate shares.[61]

4.1.6 Classifying capital investments

From what is stated in the preparatory works of the relevant tax legislation, it is obvious that return-from-capital investments should generally be taxed equally. There are three additional and superior purposes, however, in the taxation of capital investments:

1. Limitation of potential tax credits
2. Elimination of classification issues between interest and capital gains and losses
3. Effective taxation of corporate investments

In principle, the three additional purposes do not threaten the general purpose of equal taxation. If *all* capital investments were subject to limited deductibility of capital losses, equal taxation would remain. Because interest is fully deductible from capital income, however, the purpose of eliminating classification issues between interest and capital gains and losses involves the treatment of these gains and losses as equal to interest if the relevant instrument is an interest-paying one.[62] It seems necessary, therefore, to classify capital investments in at least two different categories, one of which is not subject to limited deductibility for capital losses. It can be argued, however, that it is impossible to isolate interest-paying instruments from other

[58] See Prop. 1989/90:110, part I, pp. 402–404, Prop. 1990/91:54, pp. 215–216, Prop. 1991/92:60, pp. 77–80.

[59] SOU 1989:33 part I p. 128, part II p. 162, Prop. 1989/90:110, part I, pp. 402–404.

[60] See Section 2.6 above.

[61] Prop. 1989/90:110, pp. 430–434. This is also stated in the relevant legislation: Ch. 48 § 2 IL.

[62] See Section 2.4.

financial instruments, because all financial instruments can have returns in the form of interest—for example, if they are purchased at a discount. Consequently, it seems unmanageable to find a classification norm that isolates interest-paying instruments from other financial instruments. Instead, in order to separate financial instruments with low risk or debt, the classification must focus on financial instruments with potential returns similar to a benchmark interest rate.

If it were possible to find a legal classification that captures all financial instruments with potential returns similar to a benchmark interest, everything would be fine. Such a classification would fulfill the purpose of eliminating classification issues between interest and capital gains and losses, and would also correspond with the purpose of limiting potential tax credits, because the moderate return from these instruments make them insufficient for such tax planning. The only weakness in this classification would be the potential challenge to an effective taxation of corporate investments; if it includes financial instruments with returns related or similar to a corporate share. Consequently, there must be a tradeoff between the purpose of eliminating classification issues and the purpose of effective taxation of corporate investments. A discussion of whether or not this suggested classification is mirrored in the relevant tax law is presented in the next section.

4.2 The law

4.2.1 Interpreting the law

The income tax law relevant to the taxation of capital investments originates in the tax reform of 1990. A general tendency in the statutory style of that time was to avoid enumerations in the law, and instead to formulate more abstract rules giving the courts the opportunity of dealing with new types of transactions and placing them in proper legal categories.[63] Regarding capital investments, financial instruments are divided into four categories, one of which involves the exceptional treatment of full deductibility of capital losses: debt.[64] Of the additional three categories, one captures financial instruments, with returns related to or similar to corporate shares: equity.[65] In what follows, only debt and equity will be examined.[66]

During the decade since the tax reform, several precedent-setting court decisions regarding the classification of unconventional financial instruments have been decided.[67] As a basis for these decisions, the law has been interpreted in the light of the preparatory works to the legislation, which is in line with general tax law interpretation in Sweden.[68] As illustrated in the previous section, preparatory works set out the general principles for the tax system, and thereby facilitate the interpretation of the law. It is noteworthy, however, that preparatory works can never justify an interpretation of a statute contrary to its literal meaning.[69] Thus, the challenge for the law-making authority is to find a wording of the law that facilitates,

[63] See Melz, 2007, p. 138.

[64] *Fordringsrätt*, Section 48, section 3 ITA.

[65] *Delägarrätt*, Section 48, section 2 ITA.

[66] For information on the two additional categories—foreign debt and other income—see Hilling, 2008, pp. 702–707.

[67] See footnotes 72, 74 & 75.

[68] Melz, 2007, p. 138.

[69] See Bergström, 2003, pp. 2–13 and Melz, 2007, p. 138.

in every possible case, the law being applied in concordance with the principles set out in its preparatory work (see Section 4.1.6). In the following section, we analyse the definition of debt and equity in relation to relevant court decisions. Our goal is to consult all relevant precedence court decisions since the relevant legislation was presented in 1990.

4.2.2 The legal concepts of debt and equity

The legal term 'equity' explicitly includes corporate shares and any other financial instrument giving its holder a residual interest in the assets of a company after deducting all its liabilities, such as warrants. In addition, contracts with returns that are related to the return from equity instruments are to be treated as equity for income tax purposes; options serve as one example. Consequently, *equity can be said to cover any capital investment that gives the investor the right to share in the result of the production.* To fulfil the purpose of effective taxation of corporate investments and to hinder potential tax arbitrages, speculative instruments in a corporation's production shall be treated as equity.[70]

The legal term 'debt' is defined as a claim of a certain amount of currency—a bond, for example. In addition, contracts with returns related to a debt instrument—a forward interest-rate agreement, for example—are to be treated as debt. Finally, it is explicitly stated that a financial instrument covered by the equity definition cannot be classified as debt. Thus, the trade-off between the purpose to eliminate classification issues regarding interest and capital gains and losses on the one hand, and the purpose of effective taxation of corporate shares on the other hand, is to the advantage of effective corporate share taxation.[71]

Analysing relevant case law on the classification of unconventional financial instruments, it appears that any financial instrument that gives a legal right to the invested capital is classified as a debt instrument, unless the instrument is related to equity in one way or another. Thus case law dealing with contingent debt instrument on equity and structured equity instruments classified as equity, is in line with expectations.[72] In the first of the referred cases, RÅ 1994 ref. 26, the Supreme Administrative Court (SAC) established a significant principle: that a contractually indivisible financial instrument was to be treated as a single, unique instrument for income tax purposes. Thus, the composition of a structured product is of no importance for income tax purposes.[73]

After the 1990 tax reform, the first unconventional financial instrument that SAC classified as a debt instrument was a real zero-coupon bond.[74] The fact that the potential return from this instrument was low and steady rather than volatile, and that its return was not related to equity, led to the conclusion that a classification of debt was perfectly in line with the purpose of the legislation. The same conclusion cannot be reached, however, in relation to the subsequent decision on the classification of a

[70] See Section 2.4.2.

[71] See Section 4.1.6.

[72] RÅ 1994 ref. 26 (contingent debt), RÅ 2000 not. 8 ('equity basket') RÅ 2001 ref. 21 (reverse convertible bond), RÅ 2001 not. 160 (swap), RÅ 2002 not 51 ('equity basket'), RÅ 2003 ref. 48 (contingent debt), RÅ 2007 ref. 3 (swap).

[73] See Section 3.4.

[74] RÅ 1995 ref. 71.

contingent debt instrument on foreign currencies.[75] In this decision, the SAC argued that because the instrument represents a claim in Swedish currency, it was a debt instrument; and because its return was not related to equity, it should remain classified as debt.

In this case, a literal interpretation of the law provided two possible classifications for the financial instrument. Besides its classification as debt, it would have been possible to classify it as a *forward contract (termin)*, which is defined as:

> a contract, suited for public trading, concerning
>
> the purchase of shares, bonds, or other assets at a certain future date at a fixed price or
>
> a future settlement, the amount of which is decided upon the basis of the value of the underlying asset, an exchange index, or similar.[76]

It would definitely have been possible to classify the contingent debt instrument on foreign currency as a forward contract, based on a literal interpretation of the second section of the definition. This classification would involve an income tax treatment equal to the instrument's underlying asset: foreign currency. Given the purpose and the structure of the law, it would probably have been better to exclude these instruments from the debt concept and classify them instead as derivatives. The same criticism can be leveled at the SAC's decision on a contingent debt instrument, the return of which was decided on the basis of which of three indexes had the most favourable development over the duration of the instrument.[77] Although the potential return of the contingent debt instrument was relatively volatile, it was classified as debt because its relationship to equity was not strong enough. The case law analysed indicates that the legal concept of debt generally includes all types of financial instruments that are not classified as equity and that are not derivatives with low moneyness.[78]

It can be argued, of course, that the classification of contingent-debt instruments as debt does not threaten the purposes of the tax system; because these debt instruments guarantee nominal value, they will not give rise to any capital losses. Thus, tax credits or classification issues in relation to interest will never be an issue with these instruments. It is crucial, however, to remember that financial instruments are indivisible contracts in Swedish tax law. By allowing financial instruments with risk (other than the interest-rate risk) to be classified as debt instruments raises the possibility of speculative instruments—hybrid instruments—to be classified as debt instruments. Therefore, the legal challenges are not only to isolate debt from equity, but also to include any attempt to isolate debt from several types of derivatives:

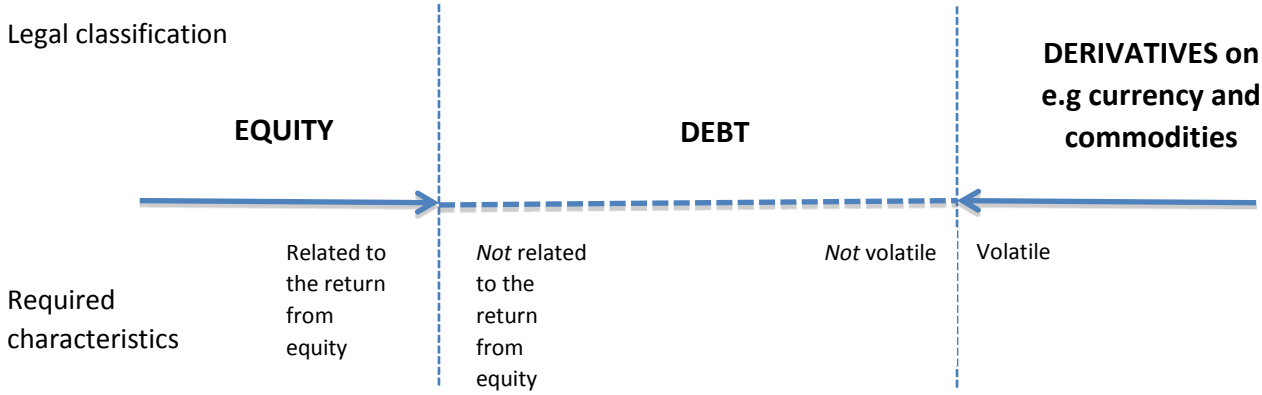
[75] RÅ 1999 ref. 69.

[76] Ch. 44, section 11 ITA.

[77] RÅ 2008 ref. 3.

[78] See Section 3.3.

Figure 2: Legal challenges in the classification of financial instruments as debt



Note: This figure shows required characteristics of financial instruments based on the purposes and structure of the law and classified as equity, debt, and derivatives on currency and commodities. Source: authors.

4.2.3 The debt–equity conundrum—financial risk

From the presentation of the legal concept of debt and equity and the presented court decisions, it is possible to conclude that equity and debt are broadly defined and that they sometimes comprise the same instruments—for example, convertible bonds. In such cases, the classification is based on the risk of the instrument rather than its legal form. Because the relevant financial risk is well defined—the risk of a corporate stock—the classification of equity is seemingly certain and efficient. It is noteworthy, however, that in many situations, a financial instrument classified as equity carries risks other than those of a corporate share. This is evident in the case of contingent debt instruments and exchange traded notes (ETNs), for example, which affected several equity investors when Lehman Brothers defaulted in 2008. Consequently, the legal concept of equity can be summarised as covering financial instruments of any kind, the potential return of which depends to a great extent on the risk of corporate stock.

4.2.4 The debt–derivative conundrum—legal form

Unlike the debt versus equity distinction, whereby the financial risk is found to be the decisive criterion for classification, the debt versus derivative distinction does not relate to financial risk. Here, the decisive criterion is legal form. Thus structured financial instruments, carrying the risks of currency or commodities, have been classified as debt according to Swedish income tax legislation.[79] The decisive criterion for a financial instrument to be classified as debt is that it should provide a claim for the investor to get the invested money in return at some future date.[80] The definition of debt does not include any requirement that the investment be risky. A literal interpretation of the concept of debt, as used in Swedish income taxation, does

[79] RÅ 1999 ref. 69 and RÅ 2008 ref. 3, see Section 4.2.2.

[80] See Section 4.2.2.

not exclude risky financial investments in commodities or currency or financial investments in bad debt—debt with large credit risks. This type of financial investment is classified as debt, therefore, unless there is another legal classification that suits the situation better. In the context of financial instruments, the only other legal classification is 'derivative'.[81]

Based on a traditional perception of the concepts of debt and derivative, where debt represents a bank deposit and a derivative is a plain vanilla forward contract with no initial value, it may seem surprising that it is sometimes difficult to separate the two types of instruments. Because the legal concepts of these instruments do not require any premises regarding financial risk or the amount of initial deposit in relation to possible return, however, the classification issue becomes problematic. There are, for example, uncertainties about the risk associated with a financial instrument before it disqualifies from the legal concept of debt, and how large an initial investment it is possible to transact in a financial instrument before it ceases to be classified as a derivative. These imprecise definitions make it possible to construct derivative-like financial instruments classified as debt. The potential high return from these instruments challenges the purpose of the legislation. The hybrids of debt and derivatives (high-risk debt instruments) constitute a key problem in classifying financial instruments. This issue is presented in Section 5 as the cause of excising the concepts of debt and equity from the Swedish income tax system.

4.2.5 Summary

An overall purpose of the Swedish income tax system is horizontal equity among different kinds of capital income—for example, interest and dividends. In the quest to achieve equal taxation, the structure of the tax system is based on the view that debt instruments are low-risk investments. For various reasons, presented in previous sections of this article, debt instruments must be separated from equity instruments and from financial instruments with other risks—for example, commodity and currency. The methods for making these distinctions when applying the law have developed differently. The distinction between debt and equity is based on financial risk. Any financial instrument with financial risk linked to equity is taxed as equity. To a great extent, this classification norm excludes risky equity instruments from the definition of legal debt. Thus, within capital income taxation, hybrid equity instruments are seldom classified as debt when the classification is based on financial risk.

The method of distinguishing between debt and hybrid instruments with the financial risk of commodities and currency, for example, is based on legal form. Given the broad legal definition of debt, it includes hybrid instruments—derivatives with large moneyness. Including these financial instruments in the definition of debt creates the possibility for arbitrage, because debt instruments are no longer necessarily low-risk investments—the assumption upon which the tax legislator designed the system.

To conclude, in a situation in which debt is treated more favourably than other financial instruments, it appears that the debt must be distinguished from these other financial instruments based on the financial risk of the instruments rather than on their legal form. Unfortunately, this is not how it works in Swedish corporate income taxation, which is presented in next section.

[81] Forward (*termin*) or Option, Ch. 44 sections 11 and 12 ITA. See Section 3.2.2.

4.3 Corporate income taxation

4.3.1 Distinguishing between debt and equity derivatives

So far we have presented the Swedish income taxation of individuals earning income from capital investment. In this context, we have recognised that the conventional tax system makes a distinction between debt and equity. Because the equity definition is based on financial risk, it is possible to classify untraditional financial instruments as debt or equity with some certainty. There are great uncertainties, however, in the classification of untraditional financial instruments as debt or derivatives because of the ever-changing characteristics of derivatives[82] and because the comprehensive definition of debt is based on legal form.[83]

The classification issues related to individuals are also relevant to corporations that make capital investments on the secondary market—for example, as part of their cash management. Unlike individuals, corporations may be subject to investments by issuing shares in their corporate assets. As is commonly known, these shares can be classified only as debt or equity.

The legal concepts of debt and equity in Swedish corporate income taxation are not identical to those used in the capital taxation of individuals, however. A key difference is that the concepts are based solely on legal form. Thus the difficulties in distinguishing between debt and derivatives in currency and commodities, as presented in relation to the taxation of individuals, are also relevant in relation to equity derivatives in corporate income taxation. Thus, equity derivatives may be classified as debt when issued by a corporation on the primary market. A regular convertible debt instrument, for example, is, in substance, a contingent debt instrument in equity; it is classified as debt rather than equity by the issuing company. More unconventional equity-linked instruments, such as Preferred Equity Certificates (PEC) and Convertible Preferred Equity Certificates (CPEC), are also considered debt according to Swedish corporate income taxation.[84] In a recent decision from the SAC, however, a mandatory convertible debt instrument was considered equity.[85] By that decision, the SAC changed the appealed advanced ruling from the Swedish Tax Board, which considered the instrument as debt.[86] Although the Board relied on private law (Swedish company law) in its classification of the instrument, the SAC based its decision on relevant classification rules in international accounting standards (IAS 32).[87] The discord between the Board and the SAC in this case illustrates the uncertainty inherent in the classification of financial instruments as debt or equity.

The importance of the classification of financial instruments as debt or equity comes down to the fact that expenses related to equity (dividends) cannot be deducted, whereas expenses in relation to debt (interest) are deductible for the issuing company. The preferred tax treatment of expenses related to debt instruments creates inducements for issuing debt instruments rather than equity.

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[82] See Section 3.4.

[83] See Section 4.2.2.

[84] See Swedish Tax Agency, 2012, pp. 88–93.

[85] HFD 2014 ref. 10.

[86] Advance ruling decided 2013-06-19 (dnr. 4-12/D).

[87] See Olsson, 2014 and Bjuvberg, 2014 for comments on this court decision.

As illustrated in Section 3.2, the return from an asset can be replicated by a bond and a derivative. Furthermore, there are few, if any, differences between a portfolio with a bond and a derivative, on the one hand, and a derivative that is a deep-in-the money option, or a prepaid forward, on the other hand.[88] Thus in order to raise capital, a company may as well issue an equity derivative with large moneyness rather than traditional corporate stock. In a case in which such a derivative is classified as debt, its issuance is more favorable when compared to the issuance of regular corporate stocks, although the value of the options are more or less equal.

To conclude, the hybrid financial instruments with characteristics of debt and equity are, in substance, derivatives with large moneyness. In Section 3.4, we have argued that these kinds of derivatives are almost impossible to classify as debt or derivative (equity) in a predictable way. The legal uncertainty will remain as long as the legal definitions do.

4.3.2 Converting capital losses into interest expenses

It can be argued, of course, that a hybrid debt instrument cannot be a derivative, because derivatives, unlike hybrid debt instruments, pay no interest—merely capital gains or losses. The issuer of the derivative may recurrently pay accrued capital losses on the derivative, however, and in that way make it appear as interest expenses.[89] Because these 'interest expenses' are, in substance, capital losses on derivatives, the rate of that 'interest' is equal to the required rate of return of the underlying asset: the issuing company's equity. Thus the rate of return on hybrid debt instruments are generally far above what can be expected from ordinary debt instruments. Swedish case law offers several examples wherein it has been considered in line with the law to deduct 'interest' at levels equal to or above what can be expected as a return on ordinary equity investments.[90]

4.3.3 Related-party debt strategies

The opportunity to issue derivatives that are legally classified as debt and to convert accrued capital losses into recurrently payable interest expenses constitutes a tool for international tax planning. When a productive company issues these derivatives (hybrid debt instruments) to a related party, such as a parent company, the deduction of the 'interest expenses' may be used to shift income between the residence countries of the related parties. If the income is produced in a high-tax regime, and the parent company is resident in a low-tax regime, the total tax for the company group will decrease. These related-party debt strategies for profit shifting have been recognised as a severe problem in international taxation and are currently being dealt with within the OECD BEPS project.[91]

4.3.4 Summary

Like several other OECD member countries, Sweden is struggling with the erosion of its corporate income tax base through extensive international tax planning with related-party debt strategies. These harmful tax strategies are the result of a legal

[88] See Section 3.3.

[89] See Section 2.5.

[90] See Swedish Administrative Court of Appeal in Stockholm, Decision No. 6953-6957-11 (2012-11-13); and Swedish Administrative Court of Appeal in Gothenburg, Decision No. 1262-1264-13 (2014-04-02).

[91] See OECD, 2013b, p. 17.

definition of debt that covers not only traditional debt instruments, but also derivatives with large moneyness. Because the characteristics of these derivatives are ever-changing between the characteristics of ordinary debt and the characteristics of the underlying (equity), the legal classification of these derivatives as debt or equity can never be carried out in a predictable way. Consequently, the classification problem related to debt and equity in Swedish corporate income taxation is, in principle, the same as the classification problem related to debt and derivatives in Swedish taxation of individuals' capital investments. In principle, the problem appears to be that legal form is used to classify financial instruments, the primary characteristic of which, according to the structure of the tax system, is their different financial risk.

5. THE PROBLEM AND HOW IT IS HANDLED

5.1 The lack of distinction between debt and derivatives

In the previous sections, we have illustrated how difficult it is to separate derivatives and debt in a predictable way when legal form is the decisive criterion. This lack of a true distinction between debt and derivative is not only problematic in relation to the taxation of individual income from capital investments, but is also a fundamental problem in Swedish corporate income taxation. How this problem threatens these two areas of Swedish income taxation and how this threat is handled by the tax legislator is presented in detail in this section.

5.2 Taxation of capital income

5.2.1 Flat tax on savings and investments

There is substantial legal uncertainty regarding the income tax treatment of capital losses from capital investments in structured 'debt instruments' with a high credit risk or a risk related to commodities. This uncertainty is also evident in relation to derivative instruments on the same underlying asset—like a *contract for differences (CFD), wherein the seller pays the buyer the difference between current value of an asset and its value at contract time (or the buyer pays the seller if the difference is negative)*. As a complement to the conventional taxation as presented in this article, a new optional type of taxation of capital investments was introduced in Sweden in 2012: flat tax on savings and investments—*Investeringssparkonto*.[92] In order to avoid confusion, we must stress that this flat tax differs from the tax on capital income in the Swedish dual-income tax system, which is often referred to as a flat rate tax (30%) on capital income.[93]

The flat tax on savings and investments diverges significantly from traditional income taxation. Instead of calculating the tax object as income, the flat tax is levied on the market value of the tax subject's financial instruments.[94] It is reminiscent of the Netherlands' Box 3 income taxation system, and has many similarities, as well, with conventional wealth taxation, which was abolished in Sweden in 2007.[95] The flat tax

[92] Prop. 2011/12:1 pp. 277–388 and Prop. 2012/13:24.

[93] See Section 4.1.2.

[94] For information on the calculation of the market value, see e.g. the Swedish Tax Agency, opinion Dnr/målnr/löpnr: 131 204738-14/111.

[95] See e.g. Lodin, 2009, pp. 114–121. About Swedish wealth taxation, see Henrekson & Du Rietz, 2014.

can be described as accrual taxation of savings and investments, which has already been discussed as a possible system in relation to the tax reform of 1990.[96]

The primary reason for introducing the flat tax on savings and investments was the large number of incorrect tax assessments caused by the complex tax regulations on capital investment. Adverse locked-in effects of the realisation principle were another reason for the new regulation. Legal uncertainty in the classification of debt, equity and derivatives was not, however, presented as a reason for the new legislation.

5.2.2 Classification issues

In order for flat tax to be applied to a financial instrument, it must be possible to establish its market value in a predictable way. Without a reliable, realistic value on the financial instrument, it remains in the conventional taxation system for capital income.[97] To secure this reliable value, the flat tax applies only on financial instruments that are traded on a regulated market or a multilateral trading facility (MTF), or are a share in an investment fund governed by Swedish regulations.[98] These premises for classification directly refer to terminology in relevant EU Directives.[99]

Because existence of a reliable market value is the decisive criterion for being an object for flat taxation, there are no legal differences among equity, debt and derivatives in this context. Thus, the classification issues mentioned previously do not exist in this system. In relation to the classification problems we analysed in this article, the flat tax is therefore found to be successful. In the following section, it is argued, however, that this success comes at a relatively high price in regard to the underlying purposes of the income tax system.

5.2.3 Purposes of the tax system

As noted in Section 5.2.1, the purpose of the flat tax on savings and investments was to facilitate capital investments for individuals,[100] but the preparatory works do not specify any other purposes served by the flat tax. Thus, the flat tax appears to be a special case in the income tax system, which is, in itself, reason for criticism, because such legislation eventually leads to fragmentation of the system. In the referral for comments that preceded the law, that criticism was addressed in the following way: 'flat tax is incomprehensible, because it is based not on a general principle such as equal taxation, but is a special case of the taxation of income in this particular area'.[101] The Swedish Government has not dealt with this criticism; nor has it considered similar opinions from several special interest groups. By introducing an alternative, optional taxation of capital investment, the general underlying purpose of the capital income taxation—equal taxation—was eventually eliminated. The taxation of income

[96] See Section 4.1.2.

[97] The valuation problem in accrual taxation is thoroughly discussed in Shakow, D. (1986) pp. 1118–1168.

[98] Section 6, Lag (2011:1268) om investeringsparkonto, and Prop. 2011/12 pp. 288–296.

[99] The Markets in Financial Instruments Directive 2004/39/EC (MiFID), and The Undertakings for Collective Investment in Transferable Securities, Directive 2001/107/EC and 2001/108/EC (UCITS).

[100] Prop. 2011/12:1 p. 277.

[101] Prop. 2011/12:1 p. 278.

differs, depending on which of the two systems are applied to the return from a financial instrument.[102]

In the preparatory works to the conventional capital taxation, it is explicitly stated that the effective taxation of corporate investments is a highly prioritised purpose of the tax system.[103] Thus the conventional taxation of financial instruments treats returns related to corporate shares alike. By introducing the flat rate taxation, however, the government introduced inefficiency in the taxation of corporate investments. An explicit exclusion of certain corporate holdings from the flat tax fragments the taxation of corporate holdings.[104] This fragmented taxation of traditional equities and several other kinds of financial instruments—those not traded on regulated markets or MTFs, for example—provides competitive disadvantages for brokers of financial instruments who are disqualified from the flat tax. This deprived group includes brokers of CFD and *financial spread betting (leveraged trading)*. Whether or not the introduction of the flat tax has had effects on corporate investments is, to our knowledge, yet to be analysed.

Subsequent purposes of the conventional tax system were to limit potential tax credits and to eliminate classification issues between interest and capital gains and losses.[105] Because the flat-tax system uses accrual recognition of all income, in principle, tax credits due to insufficient timing principles do not exist within the system. Likewise, because there is only one kind of income recognised within the system—income from savings and investments—the classification is a non-issue. Thus, in isolation, the flat-tax system handles these two purposes well. It was also considered a strong alternative to the realisation-based taxation in the tax reform of 1990.[106] The flat tax does not exist in isolation, however, and the presence of the conventional taxation of capital income must be taken into account. Under these circumstances, it is likely that classification issues and tax arbitrage opportunities will exist, not within the two systems as such, but as a result of the existence of two optional systems, with different tax treatment of financial instruments.[107] An analysis of the situations and circumstances under which these potential legal nuisances exist is, however, not within the scope of this article.

Finally it is worth mentioning that there will always be financial instruments with low and predictable returns: traditional debt instruments. By taxing the nominal return from these instruments in the same way as nominal returns from high-risk instruments, like equity derivatives, the effective tax on the real return will be unequal and in favour of the more risky instrument.[108] Thus, to treat all financial instruments alike, the tax legislators must eventually abandon the goal of horizontal equity on real income.

[102] See Starberg & Gunne, 2012, p. 151. See also Section 6 below.
[103] See Section 4.1.5.
[104] See Section 6.6.
[105] See Section 4.1.
[106] See Section 4.1.3.
[107] See Shakow, 1986, pp. 1166–1167.
[108] See Sections 6.4 and 6.5.

5.2.4 Summary

The flat tax on savings and investments is alien to the conventional income taxation of capital investments. There is no stated ambition that this tax will contribute to the fulfillment of the general purposes of capital income taxation systems, like equal taxation. And it does not. It does facilitate investments in financial instruments for individuals, however.

The design of the flat tax, in which no legal distinction is made between debt and equity, involves a new legal perception of financial instruments. In comparison to the conventional tax system, this unconventional view is more in line with the way these instruments are perceived in a pure financial context, as presented in Section 3. As a result, legal issues regarding the classification of financial instruments will likely decrease as legal certainty increases. Thus, within the flat tax system, none of the cases referred to in the presentation of the conventional tax system are relevant and would never occur in the flat-tax context. The weakness of the flat-tax system is that it requires a tax object with an objective, reliable value. Thus, several over-the-counter, non-exchange-traded instruments must be excluded. This means that there will still be taxation of financial instruments in which the distinction between debt and equity is necessary. If the flat tax system becomes as popular as the Swedish Government wishes, however, it is only a question of time before the classification of financial instruments as debt and equity is an exception to the general rule whereby all financial instruments are treated alike. This development involves the ultimate abolishing of horizontal equity and tax incentives for risky investment in exchange-traded instruments.

5.3 The taxation of corporate income

5.3.1 Specific anti-avoidance rules

As an explicit response to the aggressive tax planning with related-party interest deductions, Sweden has introduced specific anti-avoidance regulations in two steps—in 2009 and 2013.[109] Unlike most other specific anti-avoidance rules (SAAR) with the purpose of hindering this kind of aggressive tax planning (the earning-stripping rules in Germany, Norway, and Finland, for example), the Swedish rules classify interest payments as legal or illegal and tax them based on that classification.[110] They have been criticised for their vagueness and for being in conflict with EU law—the fundamental freedom of establishment.[111] As a result, a large number of advanced rulings and precedent-setting court decisions on the application of these rules have been presented.[112]

The classification of financial instruments as debt and equity is a legal problem that must be handled in order to deal effectively with the types of tax planning mentioned in this article.[113] Furthermore, the tax system is drafted and designed based on the

[109] 24 Ch. 10a-10f §§ IL.

[110] See Kleist, 2014.

[111] See Hilling, M, 2012 and Ohlsson, 2014.

[112] See e.g. HFD 2011 ref. 90 I-V, and more than ten advanced rulings presented by the Board in 2014.

[113] See Section 4.3.3.

perspectives of personal income and a view that debt is a low-risk financial instrument.[114] These premises lead to the following considerations:

1. A systematic interpretation of corporate income taxation must be conducted from the perspective of the owner (an individual) of the company, because corporate income taxation is an integrated part in individual's taxation of capital income.

2. Taxation of individuals is based on the principle of horizontal equity.

3. The tax system is structured on the assumption that debt is a low-risk financial instrument.

To deal with the legal problem based on these considerations could lead to the following argumentation: in order to achieve horizontal equity at the individual level, the return from high-risk investments must be taxed at the corporate level. Therefore, only returns from low-risk investments can be deducted at the corporate level. In practice, this leads to a risk-based classification of debt and equity in the corporate sector, which seems logical, given the structure of the system.[115]

This is not how the Swedish SAAR is constructed, however. This specific anti-avoidance rule deals with the legal problem—classification of financial instruments as debt or equity—by legitimating some debt instruments and illegitimating others, based on whether or not they have a true business purpose. Knowing that the legal problem is the result of negligence in referring to a financial instrument's financial risk when classifying it as debt or equity, it is evident that a classification norm based on business purposes could never eventually solve the problem. In fact, it appears as if it has created yet another problem.[116]

5.3.2 New corporate income taxation

To meet this criticism directed at the SAAR and to improve the corporate income tax system in general, the Swedish Government appointed a committee in 2011 to present an income tax system wherein the taxation of debt and equity in limited companies is equal. On 12 June 2014, the Swedish Committee on Corporate Taxation (*Företagsskattekommittén*) presented a proposal for new corporate income taxation.[117] The general purpose of the proposed tax system is to increase financial robustness in Swedish corporations and to prevent the Swedish corporate tax base from eroding through MNE's use of aggressive debt push-down strategies.[118] To achieve these purposes, the new tax system is designed to eliminate any difference in tax treatment based on corporate financing by debt or equity. Thus, there shall be economic neutrality between debt and equity within the corporate income tax.

To achieve economic neutrality, the Committee suggested that corporations not be allowed to deduct financial net expenses. Thus, interest expenses that have

[114] See Section 2.6.

[115] The suggestion of such a solution is presented in Hilling, A, 2012. See also Ceryak, 1990 and Politio, 1998.

[116] See footnote 111.

[117] SOU 2014:40 Neutral bolagsskatt – för ökad effektivitet och stabilitet. See Lodin, 2014 for a general presentation of the proposal.

[118] The members of the Swedish Corporate Tax Commission in DN Debatt, 2014-06-12.

historically had unlimited deductibility will only reduce the taxable result up to an amount equal to the tax subject's financial income. This mechanism, it is argued, eliminates tax incentives for economically unsound financing strategies, and removes any possibilities for eroding the Swedish corporate income tax base through the distribution of untaxed income in the form of interest expenses to foreign jurisdictions. The expected elimination of base erosion and the increase of taxable income in companies, which today are highly leveraged, enables a reduction of the corporate tax rate from 22% to 16.5%.

Unlike the SAAR, the proposal from the Committee on Corporate Taxation deals with the actual problem and solves it by treating all financial instruments equally. In relation to the underlying purpose of the tax system—equal taxation—it is only a second-best solution, however, because unlike a systematic interpretation of the legislation, the new legislation does not consider how income is taxed after it has been distributed to the individual owner of the company. Thus the proposed legislation, with a lowering of corporate income tax for most companies, actually leads to more unequal taxation, because the capital income will be taxed more favourably than labour income. Furthermore, just as in the case with the flat tax on savings and investment, by treating all financial instruments equally, horizontal equity is abolished in practice.[119]

Consequently, just as in the case of individual capital taxation, the new proposed corporate income tax system has effectively dealt with the tax loophole of a classification of financial instruments, but the solution is not related to the tax system as such. The effect, therefore, is that the fundamental principles of the tax system are not observed. Rather, the two solutions work against equal taxation, as illustrated in next section.

6. UNEQUAL TAXATION

6.1 Horizontal equity

In Sections 2 and 4, we argue that the Swedish income tax system is founded on the principle of horizontal equity, and that this principle is satisfied when the classification of a financial instrument as debt and equity is conducted with reference to their financial risk. Furthermore, we note that horizontal equity is to be satisfied not only within the taxation of capital incomes, but also in regard to income from labour. Because the total tax on income from labour was approximately 60% when the tax system was designed, horizontal equity required capital income to be taxed at approximately 60% as well. Today the total tax on income from labour remains, for most laborus, at approximately 60%, including payroll taxes.[120] Consequently, horizontal equity between capital income and income from labour is considered fulfilled in the following examples when capital income is taxed at 60% before it can be consumed by individuals.[121]

[119] See Section 5.2.4.

[120] Cf. Section 2.6.

[121] In the examples, the tax incentives for wages 'earned income tax credit' (*jobbskatteavdrag*) are not taken into account.

6.2 How to tax capital income equal to income from labour

Although the tax object is always computed on its nominal value, the relevant benchmark between wages and capital income is when the latter—capital income—is presented in terms of real income. This is so because the value of a capital investment is generally never adjusted in relation to inflation; in contrast, wages are inflation-adjusted in annual negotiations, so the value of labour can be said to be in recurrent salary negotiations. Consequently, Table 2 illustrates how the tax system is designed to target approximately 60% effective tax on real capital income. Because the presumed possible returns from debt and equity differ greatly in relation to the alleged inflation (twice as much and six times as much), it is necessary to treat them separately in order to meet the overall purpose of equal taxation.

Table 2: Taxation in accordance with the structure of the income tax system[122]

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	4.00%	1.96%	61.20%

Note: The corporate income tax and the tax on capital income was 30% of the nominal income at the time the tax system was designed. Source: authors

6.3 Taxing hybrid instruments as debt

Table 2 illustrates that high-risk return must be taxed at approximately 50% on the nominal value in order to reach the target of approximately 60% of real income. This is the reason equity income is subject to double taxation, whereas debt income is not. When the legal classification of debt comprises high-risk instruments such as derivatives with large moneyness, the effective tax on the nominal return from these instruments will remain at 30%. That results in a tax of less than 40% on real income, which is a significant departure from the target of 60%. Table 3 illustrates the consequences of the fundamental error of classifying high-risk financial instruments as debt.

Table 3: Single taxation of high-risk investments

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	12.00%	9.80%	36.72%

Source: authors

[122] The components in the columns has been calculated as follow: **Effective tax**: 1*30% [CIT] + (1-(1*30% [CIT]))*30% [Tax on capital income]; **Real Income**: (1+12% [Nominal Income]) / (1+2% [Inflation])-1; **Tax on real Income**: (100*12% [Nominal Income] * 51% [Effective tax]) / (100*9.8% [Real Income]). The figures in the columns **Corporate Income Tax**, **Inflation** and **Nominal Income** are picked to illustrate the estimations on which the legislation was designed.

6.4 Flat tax on capital

The flat tax on saving and investments dramatically lowered the capital tax on investments with high risk. Simple mathematics indicates that if an investment provides a better return than approximately 2%, the flat tax is more favourable for the investor when compared to the conventional capital tax of 30%. The greater the return, the lower the effective tax. Yet, because the double taxation of equity remains, the equality in taxation of capital income does as well, as long as only low-risk investments are classified as debt. Consequently, although the figures show equality between investments in debt and equity, the favourable treatment of capital income eventually brings the goal of horizontal equity between capital income and income from labour to an end.

Table 4: Flat tax on savings and investment

Investment	Income	Corporate income tax	Flat tax (ISK)	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	22.00%	5.23%	26.08%	2.00%	12.00%	9.80%	31.92%
Debt	Interest		15.68%	15.68%	2.00%	4.00%	1.96%	31.98%

Note: The flat tax is calculated on an average market value of 100,000 SEK during the tax year, thereby rendering a flat tax of 627 SEK in 2014. The corporate income tax rate is for 2014. Source: authors

6.5 New corporate income taxation

The proposal of the Swedish Committee on Corporate Taxation treats income from debt and equity alike, also involving economic double taxation for interest income. Together with the lowered corporate income tax rate, the effective tax on real debt income targets the original goal of approximately 60% tax. It is noteworthy, however, that the effective tax on real debt income is much lower in the new system, when compared to the conventional system, in pace with the return on the increase in debt. The lowered corporate income tax and the low flat tax on savings and investments have, however, dramatically lowered the tax on income from equity. The two new systems—flat tax and new corporate income tax—make the effective tax on real equity income less than half, compared to debt income and income from labour.

Table 5: Economic double taxation of debt and equity

Investment	Income	Corporate income tax	Flat tax (ISK)	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	16.50%	5.23%	20.86%	2.00%	12.00%	9.80%	25.54%
Debt	Interest	16.50%	15.68%	29.59%	2.00%	4.00%	1.96%	60.36%

Note: The flat tax is calculated on the same bases as in Table 5. Source: authors

6.6 Different kinds of equity

As illustrated in the tables, it appears that equity income will be heavily favoured in a future Swedish income tax system. Remember, however, that the favourable flat tax

on savings and investments applies only to publicly traded financial instruments.[123] This means that several kinds of equity instruments fall outside the flat-tax regime and must be taxed in accordance with the less favourable conventional capital tax. Depending on the character of the equity instrument, the capital tax on equity is today 30%, 25% or 20%.[124] Compared with the flat tax on savings and investments, even instruments subject to the most favourable capital tax, like close company equity, is much more heavily taxed. Thus, the flat tax on savings and investments has resulted in the tax incentive for close companies (20%) and unlisted companies (25%) being replaced with a tax incentive for investments in publicly traded companies (flat tax). In addition, the flat tax extends the unequal taxation within capital income.

Table 6: Unequal taxation of equity investments

Investment	Income	Corporate income tax	Individual income tax	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
			Flat tax (ISK)					
Public company investment	Dividends	16.50%	5.23%	20.86%	2.00%	12.00%	9.80%	25.54%
			Captal tax					
Close company investment	Interest	16.50%	20.00%	33.20%	2.00%	12.00%	9.80%	40.64%

Source: authors

6.7 Summary

Whereas the tax on income from labour, including payroll taxes, remains at approximately 60%, the tax on real capital income will have decreased step-by-step to the all-time low of approximately 26%, if the proposed new corporate income tax rules are introduced. Given these dramatic changes, and digression from the tax system's fundament of equal taxation, it is startling how the tax-legislators avoid discussions on how the proposed legislative changes relate to equal taxation, in the preparatory works of the flat tax and in the proposal from the Committee on Corporate Taxation. We hope that such discussion will occur before additional major changes are made in the system.

7. CONCLUSIONS

The purpose of this article is to present a general trend in corporate income taxation, in Sweden and elsewhere, which aims to treat debt and equity alike, and to examine how it originates from the incapacity of previous tax-law making and its interpretation and application, to determine the legal classification of certain financial instruments. Our analysis of this issue can be summarised in the following eight points:

1. The structure of the Swedish taxation of capital income is risk-based. In this context, debt is assumed to be a financial instrument with returns that are just some percentage above inflation and equity is a financial instrument with returns that could be much greater compared to debt.

[123] See Section 5.2.

[124] In this example, the tax incentives on investment deductions (*investeraravdrag*) presented in SOU 2012:3 and Prop. 2012/13:34 are not taken into account.

2. By taxing low-risk financial instruments (debt) and high-risk financial instruments (equity) differently, it is possible to achieve equal taxation of real capital income, and thereby achieve horizontal equity between capital income and income from labour.

3. The legal classification of debt and equity does not refer to the risk of financial instruments, however. Rather it focuses on the legal form, which is based on contractual considerations rather than financial risk.

4. Because financial risk is not considered when financial instruments are classified as debt or equity, the definition of debt has developed to include risky instruments, with contractual characteristics in concordance with the legal debt concept. From an economic point of view, these risky debt instruments are nothing but derivatives with large moneyness—high risk instruments.

5. Because the legal concept of debt has been extended to include risky financial instruments, the preferential tax treatment of debt can no longer be justified. Thus, what was originally a justified difference in tax treatment has turned out to be unjustifiable, because of the extended scope of the debt concept.

6. The legal problem is the wide legal definition of debt in a tax system the structure of which requires a relatively narrow definition of debt, covering only low-risk financial instruments. Instead of dealing with this problem by confining the legal concept of debt to cover only low-risk instruments, however, the tax-legislators have kept the wide definition of debt and abolished the preferential tax treatment of debt.

7. To achieve the fundamental aim of equal taxation of real capital income involves a larger effective taxation of the real income from traditional debt instruments—low-risk financial instruments, compared to the effective tax on the real income from traditional equity instruments—high risk financial instruments.

8. Horizontal equity within Swedish income taxation seems to be nothing but a memory.

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Employee views of corporate tax aggressiveness in China: The effects of guanxi and audit independence

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Abstract

This study examines the effects of *guanxi* and audit independence on the corporate tax aggressiveness of Chinese firms. Based on a survey completed by 174 respondents in 2013, we find that two types of *guanxi:* favour-seeking *guanxi* and rent-seeking *guanxi* are significantly associated with ethical judgments of corporate tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these ethical judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive associations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and favour-seeking *guanxi* and between these perceptions and stronger client-auditor relations. This study provides insights into the association between types of *guanxi* and the propensity of firm management to engage in corporate tax aggressiveness.

Keywords: *Guanxi; ethical judgments; corporate tax aggressiveness; audit independence, China; survey; international*.

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1. INTRODUCTION

The social and political relationships, or interpersonal bonds (*guanxi*), among Chinese entrepreneurs can have a profound influence on business outcomes (Sharkey, 2008; Tu et al., 2013). In China, *guanxi*, or the establishment of relationships or connections with business partners, is considered necessary to acquire resources, obtain approvals or bureaucratic privileges, facilitate the achievement of business outcomes, or reduce the risk that those outcomes will not be achieved (Hwang et al., 2009; Liu et al., 2011).

In this study, we examine the association between *guanxi* and audit independence and ethical judgments of corporate tax aggressiveness[3] in Chinese firms that operate in an international context. An evaluation of *guanxi* is important, as relations established between management and auditors and between management and government officials such as tax officials may have a bearing on management's propensity and opportunity to reduce the corporate taxes payable. Prior studies on international corporate tax aggression have demonstrated that, in many Western economies, firms can use elaborate strategies to reduce corporate income taxes, including aggressive transfer pricing, income shifting and the strategic use of debt and tax haven-incorporated subsidies (Slemrod, 2001; Rego, 2003; Braithwaite, 2005; Desai et al., 2006; Taylor & Richardson, 2013). However, little work has been carried out on managers' motivations and capabilities for reducing corporate income taxes in relation-based[4] cultural and political regimes such as China.

Based on a survey completed by 174 respondents from both listed and unlisted firms in 2013, we find that two types of *guanxi*—favour-seeking *guanxi* and rent-seeking *guanxi*—are significantly associated with judgments of tax avoidance. Perceptions of audit independence in-fact are significantly negatively associated with these judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive relations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and favour-seeking *guanxi* and between those perceptions and stronger client–auditor relations. These results are generalisable across China despite the economic and social diversity of the country's provinces because *guanxi* is pervasive throughout China's social and organisational activities, is culturally rooted, and is critical to achieving business success regardless of whether enterprises are foreign-owned, domestic government-owned, or domestic public-owned (Fan et al., 2012a).

This study contributes to the literature in several ways. Firstly, it extends the recent literature on the business decision-making of Chinese firms (see, e.g., Liu et al., 2011; Tu et al., 2013). It is also the first study to examine the association between favour-seeking *guanxi* and rent-seeking *guanxi* in conjunction with external auditor independence and perceptions of corporate tax aggression by Chinese firms. Given the size of the Chinese economy and the importance of *guanxi* in determining business

[3] Corporate tax aggressiveness is defined here as any transaction or event that leads to a reduction in the amount of corporate tax paid by the firm (see, e.g., Dyreng et al., 2010). Tax aggressiveness may be achieved through legitimate methods in accordance with tax legislation provisions or involve structuring transactions or activities with the principal objective of decreasing the amount of corporate tax payable.

[4] A relations-based economy is one in which transactions are based on personal and implicit agreements (Liu et al., 2011).

decisions and culture, it is important to gain an understanding of the relationship between these two types of *guanxi*, auditor characteristics and corporate tax aggression. Indeed, very little is known about the determinants of corporate tax aggressiveness in relation-based economies such as China. The findings of parallel studies (see, e.g., Liu et al., 2011; Tu et al., 2013) suggest that elements of *guanxi* and auditor characteristics are likely to be important determinants of Chinese business decisions, including decisions regarding tax planning and implementation. The increase in the economic importance and international influence of Chinese firms in recent years renders an assessment of how *guanxi* and audit independence relate to tax avoidance timely. Secondly, we provide additional insights into how relations developed with external auditors and clients may influence management's propensity to engage in tax-aggressive activities. We also provide evidence that, collectively, political connections, bureaucratic privilege, audit–client affiliations, and audit fee dependency are significantly associated with perceptions of corporate tax aggression. These results suggest that adverse effects such as tax aggression may arise from *guanxi*-related business dealings. Thirdly, the results presented herein can be extrapolated to other *guanxi*-related business pursuits in China and other relation-based economies. For instance, *guanxi* (and auditor independence) may exert influence on other corporate activities such as capital management initiatives and board structuring and compensation.

The remainder of this paper is organised as follows. Section 2 presents a brief review of the literature on the topics of *guanxi*, audit independence and corporate tax avoidance in relation-based economies. Section 3 develops our hypotheses. Section 4 discusses the research design. Section 5 summarises and analyses the empirical results, and Section 6 concludes the paper.

2. BACKGROUND

2.1 *Guanxi* and audit independence

Guanxi, which is loosely defined as 'interpersonal relationships', is critical in driving social behaviour and decision-making in China (Lovett et al., 1999; Fan et al., 2012a). It involves networks of individuals establishing relations to further business opportunities. Individuals are bonded through mutual obligation to one another rather than through written contracts or records (Lovett et al., 1999; Chua et al., 2009). *Guanxi* may assist in the provision of resources or enable a firm to operate effectively in a difficult environment. In China, *guanxi* networks avoid the use of written agreements, preferring social ties to achieve business objectives (Fan et al., 2013). In many cases, successful private firms have strong *guanxi* links with government officials (Fan et al., 2012a). Thus, Su et al. (2003) suggest that *guanxi* should be classified into favour-seeking and rent-seeking types. Favour-seeking *guanxi* is 'culturally rooted, signifying social contracts and interpersonal exchanges of resources in a collectivistic society' (Su et al., 2003, p. 310). Rent-seeking *guanxi*, in contrast, 'reflects on institutional norms signifying social collusion based on power exchanges in a hybrid Chinese socialist market economy' (Su et al., 2003, p. 310). Fan et al. (2012a) carried out the first empirical study examining the effects of favour- and rent-seeking *guanxi* on Chinese auditors' ethical judgments. Their results suggest that both types are associated with those judgments.

The prior literature provides a wealth of evidence indicating that *guanxi* is likely to have an important bearing on managerial incentives and capacity to achieve corporate objectives in relation-based capitalistic regimes in which politics and business ventures are closely linked. For instance, Adhikari et al. (2006) report that firms with political connections had lower effective tax rates over a 10-year period in Malaysia. Fan et al. (2008) show firms with politically connected CEOs to underperform those without connections, whereas Li et al. (2008) note that Communist Party membership helps private entrepreneurs to obtain loans from state financial institutions. Francis et al. (2009) find that firms in China with greater political connections are characterised by higher offering prices in the IPO market. Tu et al. (2013) provide evidence to show that political connections are more important in China, which has higher levels of corruption and law enforcement than developed countries. Based on this accumulated evidence, it is therefore not unreasonable to expect that reliance on social networks and political connections may affect firms' propensity to engage in tax aggression.

Audit independence is a fundamental premise of accounting professionals' code of ethics. It requires accounting professionals to bear in mind that they are required to act with integrity and in an objective manner (i.e., independence in-fact) and also avoid any activities that could create the public perception that their independence is impaired (i.e., independence in-appearance). The audit–client relationship is one of the most important issues in audit independence in-appearance. Audit independence can create real and apparent concerns in the minds of various stakeholders (Fan et al., 2013). Prior studies suggest that corporate tax aggressiveness is negatively associated with audit independence, an issue discussed in further detail in Section 3.

2.2 China's tax laws

China's income tax laws have evolved radically over the past decade (Sharkey, 2004; Deloitte, 2014; Chan et al., 2013a). The country now has transfer pricing, thin capitalisation and controlled foreign company rules, as well as a General Anti-Avoidance Rule (GAAR). The introduction of GAAR in China in January 2008 is contained in the Enterprise Income Tax Law (EITL), EITL Implementing Regulations, and Notice of the State Administration of Taxation on Issuing the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation). The 2008 EITL applies to both domestic and foreign-invested enterprises, generally at the same corporate tax rate (25%), with special rates applying in certain cases. However, the application of GAAR is not coherent in China, with different interpretations and applications being applied in different provinces (Ernst and Young, 2013). Additionally, numerous tax incentives, exemptions, and privileges are provided to firms, depending on their industry sector (e.g., qualified new and high-technology sector firms), geographical location and level of foreign investment. Industry-oriented tax incentive policies are aimed at directing investments into sectors and projects that are encouraged and supported by the state (PWC, 2012).

China's tax law and policy are developed jointly by the State Administration of Taxation (SAT) and the Ministry of Finance (MOF). The SAT is the body charged with collecting tax and enforcing compliance, and is assisted by the state and local tax bureaus at the provincial level (PWC, 2012). Enterprise income tax is imposed on the worldwide income of a resident enterprise (with a credit available for tax paid on foreign-source income), on China-source income, and on income effectively connected with the establishment in China of a non-resident enterprise. The Chinese tax authorities may impose, upon SAT approval, anti-tax avoidance measures if they

suspect that an enterprise has abused preferential tax arrangements, abused tax havens for tax-avoidance purposes, or engaged in activities with no commercial purpose such as transfer pricing or income shifting arrangements that are not at arm's length (PWC, 2012).

2.3 Tax aggression of Chinese firms

According to the US research and advocacy group Global Financial Integrity, China was subject to a US$3.79 trillion illegal capital outflow between 2000 and 2011 (Global Financial Integrity, 2012). Of the $US2.83 trillion that flowed illicitly out of China in the 2005–2011 period, $US595.8 billion ended up as cash deposits or financial assets such as stocks, bonds, mutual funds and derivatives in tax havens (Global Financial Integrity, 2012). Tax havens are jurisdictions that offer beneficial financial, legal and tax regimes, as they impose nil or nominal taxes, have laws or administrative practices that prevent the effective exchange of information, and/or lack transparency with regard to financial and taxation arrangements, including regulatory, legal and administrative provisions, and access to financial records (Hines & Rice, 1990; Wilson, 2009; GAO, 2008a; 2008b; OECD, 2006; 2012).[5] A significant portion of the capital outflows from China makes a round-trip back to the country as recorded foreign direct investment (FDI). Round-tripped FDI is given preferential treatment vis-à-vis domestic capital in the form of tax concessions and a government guarantee of the loans extended by foreign corporations to domestic firms (Global Financial Integrity, 2012).

Capital flows typically pass through the offshore financial centers of Hong Kong, the Cayman Islands or the British Virgin Islands (BVI) (Buckley et al., 2007; Sutherland et al., 2012). By 2003, the Cayman Islands accounted for 28.3 percent of total Chinese FDI flows. By 2006, it had increased to 44 percent (US$7.83 billion) (Sutherland et al., 2012). By 2006, the Cayman Islands and BVI together accounted for 47.5 percent of Chinese FDI flows and 25.3 percent of Chinese outward FDI stock. Between 2004 and 2006, the BVI received far less outward Chinese overseas FDI, but accounted for a considerable portion of direct investments back into China. Estimates of the net FDI flows from the Cayman Islands and BVI to China stood at a surplus of around US$16.5 billion in that period (Sutherland et al., 2012). Overseas FDI to the BVI is generally thought to involve assets recycled through tax havens to accomplish the preferential treatment of foreign capital (Buckley et al., 2007; Luo & Tung, 2007). Capital also leaves China as FDI in such places as Hong Kong and the BVI, only to then be laundered in another jurisdiction and reinvested in China as FDI from Hong Kong or the BVI (Global Financial Integrity, 2012). Large tax rate differentials among group subsidiaries domiciled in variably taxed jurisdictions (e.g. China, Hong Kong, the US, and various tax havens) provide incentives for firms to shift profits and deductible expenses such as interest and royalties among those subsidiaries (Huizinga & Laeven, 2008; Global Financial Integrity, 2012). The tax benefits derived from financial flows to and from tax haven-incorporated firms have important implications for inequality and corruption in China (Global Financial Integrity, 2012).

[5] The OECD's (2006, 2012) list of 33 tax havens includes the following countries: Anguilla, Antigua and Barbuda, the Bahamas, Bahrain, Bermuda, Belize, the British Virgin Islands, the Cayman Islands, the Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liberia, Malta, the Marshall Islands, Mauritius, Montserrat, Nauru, the Netherlands Antilles, New Caledonia, Panama, Samoa, San Marino, the Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, the Turks and Caicos Islands and Vanuatu.

3. HYPOTHESIS DEVELOPMENT

We now develop several hypotheses about the effects of *guanxi* and audit independence on perceptions of corporate tax aggressiveness.

3.1 Favour-seeking *guanxi*

Favour-seeking *guanxi* comprises: a) the network of relations, including management-tax department relations and broader relations, developed with the government; b) close connections between the maintenance of business relations and financial success; and c) the notion that the achievement of business objectives requires connections or affiliations with the right people. Corporate culture and managerial behaviour may influence the extent and nature of corporate tax avoidance (Dyreng et al., 2010). Faccio et al. (2007) provide evidence to show that politically connected firms are more likely to receive assistance from the government such as the receipt of tax benefits (i.e., favourable tax arrangements and payments). Perceived flexibility in terms of tax-related arrangements and negotiations between a politically connected firm and the government may serve to enhance management's aggression in tax planning and the implementation of strategies to reduce taxes payable. Appointment to a management position and the maintenance of that position may hinge on the existence of political affiliations. Chan et al. (2013b) and Jian and Zhang (2013) assert that management may have incentives to please government officials through generous tax payments. The Chinese government offers tax benefits to foreign-invested enterprises, the nature of which can be dependent on favour-seeking *guanxi*. Jian and Zhang (2013) find that foreign-invested enterprises avoid taxes to a greater extent than their state-owned counterparts based on the tax benefits the government provides them. Politically connected entrepreneurs can obtain preferential treatment from government officials based on the tenets of favour-seeking *guanxi*, which may assist their firm in deriving greater tax benefits. Management may believe that these additional tax benefits will ultimately flow to shareholders, as they serve to boost the firm's after-tax returns. Further, Lo et al. (2010) and Chan et al. (2013b) purport that management may engage in tax-aggressive activities for the purpose of increasing resource retention within the firm, which will also ultimately benefit shareholders. Thus, the government privileges provided to select firms may have overlapping governmental policy initiatives and personal and corporate objectives.

Additionally, politically connected managers may undertake more risky financial (including taxation) projects, as they may be assisted in the event of difficulties by the government or by politically connected financial institutions. Tu et al. (2013) find that politically connected firms receive preferential treatment from the government, and, as a result, acquired higher-quality firms during the full privatisation of state-owned enterprises (SOEs). Political connections may also reduce the likelihood of a tax audit or that the tax audit will result in significant penalties. In a parallel outcome to that reported by Tu et al. (2013), management may potentially abuse its political connections to exploit opportunities that enable the firm to derive greater tax benefits. Indeed, preferential tax treatment may exacerbate already aggressive tax-related activities. Further, Chan et al. (2013b) assert that it is the government that appoints, motivates and disciplines SOE managers, who are in turn required to achieve the social and political objectives of the government. To formally test the influence of favour-seeking *guanxi* on judgments of corporate tax avoidance, we develop the following (directional) hypotheses.

H1a: All else being equal, the effect of favour-seeking *guanxi* is positively associated with ethical judgments of corporate tax aggressiveness.

H1b: All else being equal, the effect of favour-seeking *guanxi* is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.2 Rent-seeking *guanxi*

Rent-seeking *guanxi* comprises: a) bureaucratic privilege, whereby it is acceptable for benefits to be channeled to some parties at the expense of others; and b) the notion that it is acceptable behaviour for dominant parties to make all decisions and deals. In a rules-based economy, this form of *guanxi* is akin to the managing director and chairperson of the firm being the same individual, who, accordingly, is unlikely to be independent. The combined role of managing director and chairperson can significantly impair both a board's important functions of monitoring, disciplining, and compensating senior managers, and its oversight, governance and disclosure policies (Kang et al., 2007). Such duality also enables the CEO to engage in opportunistic behaviour that may exacerbate the degree of information asymmetry between management and shareholders and between the firm and bondholders (Fama & Jenson, 1983; Gul & Leung, 2004). Chan et al. (2013b) find that non-government-controlled Chinese listed firms with a higher percentage of board shareholdings and a CEO who also serves as the board chair tend to be more tax aggressive than SOEs and firms with stronger governance structures. That finding implies that the existence of managers who assert control and attain bureaucratic privilege can diminish management's monitoring capacity and increase the likelihood of tax aggressiveness. To formally test the influence of rent-seeking *guanxi* on corporate tax avoidance, we develop the following (directional) hypotheses.

H2a: All else being equal, the effect of rent-seeking *guanxi* is positively associated with ethical judgments of corporate tax aggressiveness.

H2b: All else being equal, the effect of rent-seeking *guanxi* is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.3 External auditor independence in-fact

We examine the relationship between respondents' opinions regarding judgments of corporate tax aggressiveness in order to determine: a) whether the external auditing firm should be independent in performing an audit; and b) whether the auditor should behave with integrity and objectivity in performing the audit. Frankel et al. (2002) provide empirical evidence showing that the provision of non-audit-related services reduces auditor independence and thereby lowers the quality of the firm's financial information. Alexander et al. (2008) find that the opportunities for firm management to engage in corporate tax aggressiveness increase as audit independence diminishes. Elder et al. (2008) report empirical support for the idea that auditor-provided tax services reduce auditor independence. Finally, Armstrong et al. (2012) find that the higher the proportion of taxation fees provided by the auditor, the lower the level of the firm's effective tax rate. In the Chinese context, Shafer and Simmons (2011) demonstrate that certain dimensions of an ethical culture exert a significant effect on Chinese tax practitioners' intentions to engage in tax-aggressive strategies. We

therefore posit that firms with weak external auditor independence are more likely to engage in tax aggressiveness. To formally test the influence of external auditor independence in-fact on judgments of corporate tax aggressiveness, we develop the following (directional) hypotheses.

H3a: All else being equal, the likelihood of external auditor independence is negatively associated with ethical judgments of corporate tax aggressiveness.

H3b: All else being equal, the likelihood of external auditor independence is negatively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

3.4 External auditor independence in-appearance

We now examine the relationship between respondents' opinions regarding judgments of corporate tax aggressiveness and whether the external audit firm should: a) avoid a close relationship with clients; b) avoid an employment offer from a client; and c) avoid dependency on the derivation of fee revenue from a particular client or small client group. In a rules-based or Western economy, independence in-appearance by an external auditor is likely to be negatively associated with the likelihood of a firm engaging in corporate tax aggressiveness. If auditors develop connections with clients and become financially reliant on substantial fees from those clients (particularly fees related to non-audit services), then the auditors' independence is potentially compromised, as they may become reluctant to draw attention to problems with the clients' tax or other business-related activities (Becker et al., 1998; Freise et al., 2008). However, Liu et al. (2011) contend that the relationship between auditor-management affiliations and audit quality depends on the behavioural and business context. In the case of a relation-based economy such as China, linkages developed between external auditors and management appear to be essential to achieving financial (including taxation) objectives and are based on familiarity and trust between the parties concerned (Chua et al., 2009). These authors further contend that auditor-management affiliations increase the likelihood that a firm will receive a clean audit opinion. Similarly, these affiliations may be regarded as essential in achieving the firm's financial (and taxation) objectives and strategies. Further, Gul (2006) finds that Malaysian firms with political connections are characterised by the use of external auditors that exert greater audit effort and charge higher audit fees. Finally, the Chinese audit market is effectively controlled by the government[6] (Liu et al., 2011). It is therefore not unreasonable to assert that closer connections between external auditors and management may facilitate aggressive tax-avoidance strategies. To formally test the influence of external auditor independence (in-appearance) on judgments of corporate tax aggressiveness, we develop our final set of (directional) hypotheses:

H4a: All else being equal, an external auditor's affiliation with management is positively associated with ethical judgments of corporate tax aggressiveness.

[6] The Chinese government controls the audit market through the Chinese Institute of Certified Public Accountants (CICPA), which is effectively controlled by the MOF. Further government control of the audit market stems from the services of CICPA being used by local governments (Wang et al., 2008).

H4b: All else being equal, an external auditor's affiliation with management is positively associated with ethical judgments that corporate tax aggressiveness is a good business strategy for the firm and its shareholders.

4. RESEARCH DESIGN

4.1 Sample selection and methodology

The study reported herein used a survey to collect data on perceptions of corporate tax aggression and the benefits of that aggression. The survey instruments comprised: (1) a self-administered questionnaire and (2) two hypothetical cases of corporate income tax aggression (Appendix C). The self-administered questionnaire solicited demographic information (age, gender, qualifications and position) and asked questions about Chinese business personnel's perceptions of *guanxi* (Appendix A) and audit independence (Appendix B). The study sample comprised Chinese business personnel enrolled in an MBA course at either Zhongnan University of Economics and Law or Dongbei University of Finance and Economics who are also currently employed by listed and unlisted companies located in Hubei and Liaoning provinces. Independent instructors recruited the participating MBA students, asking them to complete the questionnaire at the end of class. The instructors provided students with an information sheet and also explained the objectives and importance of the questionnaire and how to complete it. Respondents were assured that their responses would be anonymous and confidential, with no personal information relating to respondents or their employing firm disclosed. Responses were given on a nine-point Likert scale anchored on 'strongly disagree' (1) and 'strongly agree' (9). The survey instrument was translated from English to Chinese by a professional translator. The Chinese version was then pre-tested on the MBA instructors to identify any potential problems with understanding prior to administration to the participating MBA students. A sample of 176 Chinese business personnel studying an MBA course was used to collect information on the two types of *guanxi* and corporate tax avoidance by Chinese firms. Two incomplete survey instruments were excluded from the study, resulting in a final useable sample of 174. Demographic information pertaining to the respondents is provided as Table 1.

Table 1: Demographic attributes of Chinese business personnel that responded to the questionnaire

1 2 3 4 5 6 7 8 9
Strongly Disagree — Strongly Agree

		Sample size	%
Gender	Male	90	52
	Female	84	48
Education level	Bachelor	131	75
	Master	41	24
	Other	2	1
Age (years)	20–30	111	64
	31–40	60	35
	41–50	3	1
	51 above	0	0
Position	Independent board of director	1	1
	Non-independent board of director	5	3
	Financial controller/manager	17	10
	Department manager	39	22
	General staff	82	47
	Accounting staff	30	18

4.2 Dependent variable

Our dependent variable is: a) a respondent's likely ethical judgment on two tax-aggressive activities (see Appendix C) undertaken by a firm if they were an executive director of that firm and b) the respondent's ethical judgment on whether the business strategy of the firm undertaking those activities was beneficial to the firm and all of its shareholders. The two tax-aggression cases revolve around two important mechanisms by which firms can reduce the corporate taxes they pay. The first case involves the repatriation of funds from a tax haven-incorporated subsidiary located in the BVI back to a parent firm in mainland China. The second involves the shifting of income and borrowings between a mainland Chinese firm and a Hong Kong subsidiary to obtain tax benefits in the form of lower taxes on income and higher deductions on borrowings, depending on where the funds are taxed. It is likely that tax-aggressive firms will incorporate subsidiaries in tax havens to avoid having their foreign income subject to domestic corporate taxes (Desai et al., 2006). Both cases involve tax-aggressive activities by Chinese multinational firms rather than SOEs.

Respondents were asked to indicate their level of agreement with four questions on a 9-point Likert scale ranging from 'strongly disagree' (1) to 'strongly agree' (9). The first two questions, designed to measure the first dependent variable, that is, corporate tax aggressiveness, concerned their perception of whether management had aggressively avoided paying corporate taxes to the government in the two cases. The last two questions, used to measure the second dependent variable, that is, tax business

strategy, concerned the companies' tax business strategy in the two cases. An internal consistency test revealed that the alpha reliabilities of both tax aggressiveness (two items) (58%) and tax business strategy (two items) (62%) were acceptable given the small number of representative items.

4.3 Independent variables

Our independent variables are *guanxi* and audit independence. *Guanxi* includes the two dimensions of favour-seeking *guanxi* and rent-seeking *guanxi*, and audit independence the two dimensions of audit independence in-fact and in-appearance. The level of Chinese business personnel's favour- and rent-seeking *guanxi* orientations were measured using the seven-item *guanxi* scale in Fan et al. (2012b), and their level of perceptions of audit independence in-fact and in-appearance were measured using the seven-item audit independence scale in Fan et al. (2012c). Confirmatory factor analysis (CFA) using analysis of moment structures (AMOS) was performed to assess each original measurement model's goodness-of-fit. The purpose of this exercise was to confirm the most appropriate measurement model for each independent variable in the current sample. Model assessment was conducted using X^2 statistics ($p \geq 0.05$) (Jöreskog and Sörbom, 1993) and $X^2/df < 2$ (Wheaton et al., 1977) and goodness-of-fit indices such as CFI ≥ 0.95 (Bentler, 1990) and root mean square error of approximation (RMSEA) ≤ 0.06 (Hu & Bentler, 1999).

The results of CFA on the *guanxi* variable (i.e., p = 0.000, $X^2 = 178.16$, df = 13, $X^2/df = 3.41$, comparative fit index [CFI] = 0.93 and RMSEA = 0.12) indicated a very poor fit for the two-factor seven-item model based on the model assessment criteria (refer to the previous section). Thus, model re-specifications were undertaken to find a model that better represented the data. After reviewing the significant values of the modification indices and standardised residual covariance (i.e., larger than two) (Jöreskog & Sörbom, 1989; Steenkamp & Baumgartner, 1998), the items *right people* and *back-door deals* were found to represent misspecifications of the original model. They were therefore deleted incrementally, and the final results (i.e., p = 0.11, $X^2 = 7.34$, df = 4, $X^2/df = 1.84$, CFI = 0.99 and RMSEA = 0.07) suggested that this short version of the model was most appropriate for the current sample, although the RMSEA value (0.07) was slightly higher than the predetermined criteria (0.06). However, such results are still considered a good fit in the literature (e.g., Cheung & Rensvold, 2002; Du & Tang, 2005; Vandenberg & Lance, 2000). Accordingly, we used the two-factor five-item model in data analysis examining Chinese business personnel's *guanxi* orientations and in further analysis, that is, of those orientations' influence on Chinese business personnel's judgments about tax aggressiveness. The overall reliability coefficient using Cronbach's alpha for favour-seeking *guanxi* is 0.78, and that for rent-seeking *guanxi* is 0.72.

Similarly, the CFA results for the audit independence variable (i.e., p = 0.000, $X^2 = 161.68$, df = 14, $X^2/df = 11.55$, CFI = 0.79 and RMSEA = 0.25) also indicated a very poor fit for the two-factor seven-item model based on the model assessment criteria. Analysis suggested that the items *resist client pressures to maintain independence* and *avoid dependency on certain clients* represent likely misspecifications of the model. Hence, CFA was conducted again with these two items deleted one-by-one until a satisfactory model was identified. The final results (i.e., p = 0.19, $X^2 = 6.07$, df = 4, $X^2/df = 1.52$, CFI = 0.99 and RMSEA = 0.06) suggested that the short version of the model was most appropriate for the current sample. Accordingly, it was used to examine Chinese business personnel's perceptions of audit independence and to

further examine their ethical judgments concerning tax aggression. The results of the Cronbach's alpha measure indicated that both audit independence in-fact (0.85) and in-appearance (0.83) were reliable.

4.4 Control variables

Four demographic control variables were included in the study: gender, qualifications, age and position in the firm. Gender (GEN) controlled for differences in the business ethics of the female and male respondents with respect to their judgments concerning corporate tax avoidance. Betz et al. (1989) and Peni & Vähämaa (2010) find firms with female CFOs to adopt a more conservative, risk-averse financial reporting style than their counterparts with male CFOs. Fallan (1999) observes that female students adopt a stricter attitude towards tax evasion than their male peers. It was thus likely that female respondents would tend to take a stricter view of corporate tax aggressiveness than their male counterparts. GEN takes a value of 1 if the respondent is female and of 0 otherwise.

Respondents' age (AGE) was included to control for the level of experience and monitoring capacity (Ferris et al., 2003). Cochran et al. (1984) claim that younger managers are perceived to have greater career growth opportunities because they are more likely, and willing, to make risky corporate decisions and undertake risky activities. Hence, younger managers may also be prepared to undertake risky activities in terms of tax aggression, and thus may have a stronger preference for such aggression.

The qualifications (QUAL) of respondents was also included as a control variable because it was expected that more qualified respondents would make more informed judgments regarding tax-aggressive planning and its effects on the firm and its shareholders. Finally, their position (POS) was included to control for differences in professional ability, knowledge and monitoring capacity with respect to corporate tax avoidance. Recent research (e.g., Frank et al., 2009; Dyreng et al., 2010) suggests that aggressive tax planning is associated with managerial opportunism and capabilities. Managers can use their professional ability and knowledge effectively to gauge whether firms are undertaking risky and aggressive tax planning activities and to monitor compliance with applicable tax laws (Carter et al., 2010).

4.5 Base regression model

Our base ordinary least squares (OLS) regression model is estimated as follows:

$$CTA_i \text{ or } CTS_i = \alpha_{0it} + \beta_1 FG_i + \beta_2 RG_i + \beta_3 AUDIND_i + \beta_4 CLREL_i + \beta_5 GEN_i + \beta_6 AGE_i + \beta_7 QUAL_i + \beta_8 POS_i + \varepsilon_i \quad (1)$$

where:

i = respondents 1 through 174;

CTA = ethical judgment that firm is aggressively avoiding paying tax to the government from executive directors perspective based on two international cases (see Appendix C);

CTS = ethical judgment that corporate tax planning from executive director's perspective is good for the firm and its shareholders based on two international cases (see Appendix C);

FG = favour seeking *guanxi* comprised of three items;

RG = rent seeking *guanxi* comprised of two items;

AUDIND = external auditor independence comprised of two items;

CLREL = external auditor and client relationship comprised of three items;

GEN = a dummy variable of 1 if the respondent is female, otherwise 0;

AGE = age of the respondent in years measured as 1 if the respondent is aged between 20–30 years, 2 if the respondent is aged between 31–40 years, 3 if the respondent is aged between 41–50 years and 4 if the respondent is aged from 51 years;

QUAL = the highest qualification of the respondent scored as 1 if a bachelor degree, 2 if a post graduate master degree is held and 3 if a post-doctoral degree;

POS = nature of position held in the firm scored as 1 through to 5 for each of non-independent board, independent board member, financial controller, department head, administration staff and accountant respectively;

ε = The error term.

5. EMPIRICAL RESULTS

5.1 Descriptive statistics

Table 2 reports the descriptive statistics for the dependent variables (ethical judgment that the firm is aggressively avoiding paying tax (CTA) and ethical judgment that corporate tax planning is good for the firm and its shareholders (CTS)), the independent variables (favour-seeking *guanxi* (FG), rent-seeking *guanxi* (RG), auditor independence (AUDIND) and external auditor–client relationship (CLREL)), and control variables (GEN, AGE, QUAL and POS). Dependent variables CTA and CTS have a mean (standard deviation [s.d.]) of 5.51 (1.33) and 5.10 (1.44), respectively. FG has a mean (s.d.) of 7.95 (1.35), indicating that respondents strongly believed, on average, that the development and maintenance of a network of relationships with individuals likely to be useful in business was a necessary requirement for business success. Their perception was that business is conducted by and through networks held together by strong social relations. RG has a mean (s.d.) of 3.91 (2.11), indicating that respondents maintained a weak belief, on average, that bureaucratic privilege is acceptable and that dominant parties can make all decisions. AUDIND has a mean (s.d.) of 8.33 (1.41), suggesting that respondents strongly agreed, on average, that external auditors should be independent in performing audits and should conduct those audits with integrity and objectivity. Finally, CLREL has a mean (s.d.) of 7.65 (1.60), indicating that respondents strongly agreed, on average, that external

auditors should avoid a close relationship with clients, employment offers from clients and conflicts of interest involving clients. The mean, standard deviation and range of control variables are also presented in Table 2. An acceptable range of variation is observed for all variables, and there is a reasonable level of consistency between the means and medians, reflecting the normality of the distributions.

Table 2: Descriptive statistics—full sample

Variable	N	Mean	Std. Dev.	Minimum	Maximum
CTA	174	5.51	1.33	1	7
CTS	174	5.10	1.44	1	7
FG	174	7.95	1.35	1	9
RG	174	3.91	2.11	1	9
AUDIND	174	8.33	1.41	1	9
CLREL	174	7.65	1.60	1	9
GEN	174	0.48	.501	0	1
AGE	174	1.38	.521	1	4
QUAL	173	2.23	.436	1	3
POS	169	4.63	1.02	1	5

Variable definitions: CTA = ethical judgment that firm is aggressively avoiding paying tax to the government from executive directors perspective based on two international cases (see Appendix C); CTS = ethical judgment that corporate tax planning from executive director's perspective is good for the firm and its shareholders based on two international cases (see Appendix C); FG = favour seeking guanxi comprised of three items; RG = rent seeking guanxi comprised of two items; AUDIND = external auditor independence comprised of two items; CLREL = external auditor and client relationship comprised of three items; GEN = a dummy variable of 1 if the respondent is female, otherwise 0; AGE = age of the respondent in years measured as 1 if the respondent is aged between 20–30 years, 2 if the respondent is aged between 31–40 years, 3 if the respondent is aged between 41–50 years and 4 if the respondent is aged from 51 years; QUAL = the highest qualification of the respondent scored as 1 if a bachelor degree, 2 if a post graduate master degree is held and 3 if a post-doctoral degree; POS = nature of position held in the firm scored as 1 through to 5 for each of non-independent board, independent board member, financial controller, department head, administration staff and accountant respectively.

5.2 Correlation results

The Pearson pairwise correlation results are reported in Table 3. We find significant correlations (with predicted signs) between CTA and CLREL, between GEN and CTS and FG, and between CLREL and GEN. Table 3 also shows that only moderate levels of collinearity exist between the independent variables. We computed variance inflation factors (VIFs) when estimating our base regression model to test for signs of multicollinearity between these variables. No VIFs exceeded 5, and thus multicollinearity was deemed not to be a problem in our study (Hair et al., 2006).

Table 3: Pearson correlation results

	CTA	CTS	FG	RG	AUDIND	CLREL	GEN	AGE	QUAL	POS
CTA	1.00									
CTS	0.50**	1.00								
FG	0.12	0.23*	1.00							
RG	0.11	0.10	0.37**	1.00						
AUDIND	-0.01	0.05	0.47**	-0.07	1.00					
CLREL	0.20*	0.18*	0.49**	0.03	0.68**	1.00				
GEN	-0.16*	-0.14*	-0.14*	-0.03	-0.08	-0.12	1.00			
AGE	-0.02	0.00	0.16*	-0.14*	0.08	0.12	-0.15	1.00		
QUAL	-0.02	0.04	0.08	-0.07	0.00	0.10	0.07	0.25*	1.00	
POS	0.03	0.01	-0.09	-0.06	0.07	-0.01	0.09	-0.35*	-0.03	1.00

Variable definitions: see Table 1 for variable definitions.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively. The p–values are one-tailed for directional hypotheses and two-tailed otherwise.

5.3 Regression results

Table 4 reports the regression results for our base regression model. We find that CTA has a significantly positive association with FG ($p < .10$), RG ($p < .05$) and CLREL ($p < .10$), and a significantly negative association with AUDIND ($p < .10$). The respondents judged firms engaged in aggressive tax activities to be more likely to have established favour- and rent-seeking *guanxi* networks. Additionally, they judged that firms engaged in these activities also tended to have stronger client–auditor relations (auditor independence in-appearance) and weaker auditor independence (auditor independence in-fact). Thus, the results support H1a, H2a, H3a and H4a. We also find CTS to have a significantly positive association with FG ($p < .05$) and CLREL ($p < .10$). The respondents believed that tax aggressive activities are good for the firm and its shareholders when favour- but not rent-seeking *guanxi* relations were in place. These results support H1b, but not H2b. Further, respondents who believed that tax-aggressive activities are good for the firm and its shareholders tended to have stronger opinions about client–auditor relations (auditor independence in-appearance), thus supporting H4b. No significant difference is observed between CTS and AUDIND, and hence H3b is not supported. Moreover, female respondents tended to judge firms as less tax-aggressive than their male counterparts. The other control variables are not significant. Our model has variably significant predictors, but low absolute adjusted R-square values (8.8% or 14%), possibly because of the dispersion in those values around a line of best fit. Although the adjusted R-square values are small in absolute terms, they do not detract from the usefulness of our model, as we find a consistent and reliable association between CTA or CTS and the predictor variables.

Overall, our regression results show that the two types of *guanxi*, favour-seeking and rent-seeking, are significantly associated with ethical judgments about corporate tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these ethical judgments, whereas audit independence in-appearance is

positively associated with them. Further, we find significantly positive relations to exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and both favour-seeking *guanxi* and stronger client–auditor relations.

Table 4: Regression results—base regression model

$$CTA_i \text{ or } CTS_i = \alpha_{0i} + \beta_1 FG_i + \beta_2 RG_i + \beta_3 AUDIND_i + \beta_4 CLREL_i + \beta_5 GEN_i + \beta_6 AGE_i + \beta_7 QUAL_i + \beta_8 POS_i + \varepsilon_i$$

Variable	Predicted sign	CTA	Predicted sign	CTS
Intercept	?	.3.283 (2.914)**	?	.2.14 (1.736)*
FG	(H1a) +	.173 (1.850)*	(H1b) +	.263 (2.583)**
RG	(H2a) +	.107 (2.073)**	(H2b) +	.043 (.761)
AUDIND	(H3a) –	-.169 (-1.871)*	(H3b) –	-.118 (-1.215)
CLREL	(H4a) +	.163 (1.928)*	(H4b) +	.147 (1.731)*
GEN	?	-.374 (-1.819)*	?	-.352 (-1.556)
AGE	?	.088 (.398)	?	-.018 (-.074)
QUAL	?	.089 (.362)	?	.324 (1.207)
POS	?	.180 (1.675)	?	.080 (.668)
Adj. R^2 (%)		14.00%		8.80%
N		174		174

Variable definitions: See Table 2 for variable definitions.

*, **, and *** indicate significance at the .10, .05, and .01 levels, respectively.

[a]Coefficient estimates with the *t*-statistics in parentheses.

5.4 Robustness checks

We performed several robustness checks to assess the reliability of the regression results reported in Table 4. First, we carried out the Breusch–Pagan/Cook–Weisberg test for heteroskedasticity, as the variability of a dependent variable such as CTA or CTS may be unequal across the range of values of a predictor variable. This test tests the null hypothesis that the error variances are all equal versus the alternative that they are a multiplicative function of one or more variables. Using either CTA or CTS as the dependent variable, the Breusch–Pagan/Cook–Weisberg test indicated that our data is homoscedastic, as we obtained small chi-square values and non-significant p-values. Second, we dropped all of the control variables from the regression model, and obtained similar results for FG, RG, AUDIND and CLREL. Third, we entered the

control variables consecutively into the regression model,[7] and our main findings remained unchanged. Finally, we added each of our four independent variables successively into the regression model to test the stability of the regression coefficients and robustness of our results. On the whole, the regression coefficients for FG, RG, AUDIND and CLREL were stable and statistically significant (with the predicted signs).

6. CONCLUSIONS

In this study, we examine the association between *guanxi* and audit independence and ethical perceptions of corporate tax aggressiveness in Chinese firms that operate in an international context. Based on a survey completed by 174 respondents in 2013, we find that two types of *guanxi*, favour-seeking *guanxi* and rent-seeking *guanxi*, are significantly associated with ethical judgments of tax aggressiveness. Perceptions of audit independence in-fact are significantly negatively associated with these judgments, whereas audit independence in-appearance is positively associated with them. Further, significantly positive relations exist between perceptions that tax-aggressive activities are good for the firm and its shareholders and both favour-seeking *guanxi* and stronger client-auditor relations. This study contributes to the literature on the importance of *guanxi* in influencing managerial activities, opportunism and business outcomes. It also empirically demonstrates that audit independence and the client–auditor relationship play a critical role in influencing managerial behaviour.

This study is subject to several limitations. First, the sample was drawn from respondents asked to make judgments regarding *guanxi*, auditor independence and tax avoidance as if they were the CEO of a firm. Second, our base regression model may have been incomplete. For example, the role of tax authorities could have an effect on international tax avoidance activities. Future research should consider this issue.

[7] Entering control variables progressively into a regression model provides an indication of whether a particular control variable is significantly driving the model outcomes (Hair et al., 2006).

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8. APPENDICES

8.1 Appendix 1: *Guanxi* orientation

a. Favour-seeking *guanxi*
1) In business, it is important to maintain a good network of relationships
2) Maintaining good relationships is the best way to enhance business
3) Doing business involves knowing the right people
4) Developing the right contacts helps in the smooth running of a business

b. Rent-seeking *guanxi*
1) Back-door deals are alright as long as those involved in the process benefit
2) Bureaucratic privilege, which benefits some parties at the expense of others is to be expected
3) It is acceptable behaviour for the dominant parties to a deal to make all the decisions.

(Source: Fan et al., 2012b)

8.2 Appendix 2: Code of professional ethics

Do you regard it as reasonable to expect auditors:
a. Independence in-fact
1) to be independent in performing an audit?
2) to act with integrity and objectivity in performing an audit?
3) to resist clients' pressures to maintain independence?

b. Independence in-appearance
4) to avoid a close relationship with clients?
5) to avoid an employment offer from a client?
6) to avoid dependency on fees from certain clients?
7) to avoid a conflict of interest with clients?

(Source: Fan et al., 2012c)

(The *guanxi* scale is extracted from survey questionnaire. The respondents were asked to circle the one answer that best describes his/her view of each question using a nine-point Likely scale from 'Strongly disagree' (1) to 'Strongly agree' (9)).

8.3 Appendix 3: Corporate tax aggression cases

Situation 1
Company A manufactures steel in China. It is listed on the Shanghai stock exchange. The management of Company A decides to list on the New York Stock exchange and establish an offshore subsidiary in the British Virgin Islands (BVI). BVI is characterised by secrecy laws making it difficult for tax authorities to trace the flow of profits from a company to the BVI and then back to mainland China. Thus Company A transfers profits to a holding company in the BVI and waits for two years, when it then sends the profits back to mainland China disguised as 'foreign investment', which is either not taxed or taxed at a lower rate than in China.

Situation 2
Company A also establishes a subsidiary in Hong Kong, which is listed on the Hong Kong stock exchange. Company A makes large profits which are sent to a subsidiary in Hong Kong. The transfer of funds from Company A to the Hong Kong company is disguised as service fees or dividends. Management of company A has sent the funds to Hong Kong because they are subject to relatively

lower corporate tax rates (16.5% in Hong Kong as opposed to 25% in mainland China) meaning that overall tax payable for the corporate group is lower. At the same time, the Hong Kong company borrows funds in Hong Kong and then sends the funds back to company A for its use. Company A can claim a greater corporate tax deduction on the borrowed funds owing to the tax rate differences between China and Hong Kong.

Assume **you are currently an executive director working for Company A who had nothing to do with the establishment of any of the above tax arrangements**. Please answer each question, circling **one** number that best describes the extent of your agreement.

1. I believe that Company A is aggressively avoiding paying tax to the government with respect to **Situation 1**.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

2. I believe that Company A is aggressively avoiding paying tax to the government with respect to **Situation 2**.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

3. In respect of **Situation 1**, I believe that the business strategy of Company A is good for the firm and all of its shareholders.

1	2	3	4	5	6	7	8	9
Strongly Disagree								Strongly Agree

4. In respect of **Situation 2**, I believe that the business strategy of Company A is good for the firm and all of its shareholders.

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Tax compliance behaviour in Australian self-managed superannuation funds

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Abstract

The rapid growth of self-managed superannuation funds (SMSFs) in Australia over the past two decades has been mirrored by a host of legislative and taxation rulings regulating the sector. The need for trustees to remain compliant with the relevant regulations is of paramount importance given the severity of the penalties they face for contraventions. We review the main rules governing SMSF compliance along with several notable legal cases of non-compliance. We then provide a comprehensive quantitative analysis of compliance outcomes in 321 SMSFs from across Australia.

This research paper focusses only on SMSF trustee behaviour in respect of funds where the auditor has reported a breach. It does not refer to SMSF funds that are technically non-compliant as that term is defined in s 42A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act). Therefore, in terms of this paper, whenever a SMSF is referred to as non-complying regard is only had to a SMSF where an auditor has reported a breach of any of the regulatory rules.

The results of our research suggest that trustee literacy is positively associated with fund compliance, whereas trustee overconfidence cannot be linked with compliance outcomes for the sample. Moreover, compliant funds also appear more likely to allocate a greater share of their superannuation portfolios to conservative asset classes (cash and domestic equities), typically linked with under-diversification in SMSFs. Our findings therefore suggest that the financial risks borne by under-diversified SMSFs may at least in part be offset by a lower compliance burden for these funds.

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1. INTRODUCTION

Australia's retirement savings regime has been part of the tax reform agenda for many decades and is still a part of current tax reform debate.[5] This retirement savings regime was also addressed in detail in the final report of the AFTS review with seven of the 138 recommendations specifically relating to retirement incomes.[6]

In theory, Australia's retirement income system is designed to encourage individuals to self-fund their retirement through a voluntary and compulsory contributions scheme with a government pension scheme acting as a safety net for those who are unable to fully self-fund their retirement incomes. This regime is collectively known as the 'three-pillar' structure of the retirement income system. These three pillars are; the age pension; compulsory superannuation and voluntary superannuation.

It is the second and third pillars (the superannuation pillars) that receive the current tax concessions concerning contributions to a 'complying superannuation fund'. These include a lower tax rate of 15% that applies to earnings of complying superannuation funds and various other tax concessions surrounding superannuation such as the nil or reduced rates of tax that apply when members withdraw their benefits from a superannuation fund.[7]

2. WHAT IS A SELF-MANAGED SUPERANNUATION FUND (SMSF)?

Section 17A of the *Superannuation Industry (Supervision) Act* 1993 (**SIS Act)** sets out the basic conditions that must be satisfied for a superannuation fund to be a self-managed superannuation fund (**SMSF).** Section 17A provides that in order for a superannuation fund to be a SMSF it must have fewer than five members and that if the trustees are individuals that each individual trustee is also a member of the fund and that individual members must also be trustees of the fund.

If the trustee is a body corporate then each director of the body corporate must be a member of the fund and each member of the fund must also be a director of the body corporate. This essentially means that members of an SMSF must take responsibility for the assets managed by the self-managed superannuation fund.

Subsection 17A (3) of the SIS Act does provide that other persons who are not members of the fund can be a trustee in specified circumstances, such as when the member is under a legal disability or when the member has died. In both cases the Legal Personal Representative of the member under a legal disability or the deceased member will also be regarded as a trustee of the SMSF. For ease of reference, in the rest of this paper the term 'trustee of an SMSF' will be used for both individual trustees and corporate trustees.

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[5] K Sadiq, 'Prescriptions for reform of Australia's superannuation tax concessions' (2012) 27 *Australian Tax Forum* 372.

[6] *Australia's Future Tax System, the Retirement Income System Report on Strategic Issues,* May 2009.

[7] A complying superannuation fund is defined under the *Superannuation Industry (Supervision) Act 1993* (Cth). The concessions that a complying superannuation fund are eligible for include a flat rate of taxation of 15% on fund income and deductible contributions and superannuation benefits paid to a member aged at least 60 are generally tax-free, whether paid as a lump sum or as an income stream.

According to the Australian Prudential Regulation Authority (APRA) and its *Quarterly Superannuation Performance (interim edition)* for September 2014, there were 539,375 SMSFs in Australia with more than 1 million members and some $558.6 billion of assets invested. This comprises about 30% of assets invested in superannuation in Australia.[8] The SMSF portion is therefore a very large part of Australia's superannuation sector and statistics indicate the SMSF portion is growing by about 7–8% per annum.[9]

3. RULES GOVERNING THE OPERATION OF SMSFS IN AUSTRALIA

The obligation on SMSF trustees to comply with the stringent regulatory requirements contained in the SIS Act, SIS Regulations and the *Financial Sector (Collection of Data) Act 2001* (Cth) is designed to ensure that SMSF assets are kept in accordance with a sole purpose test as set out in s 62 of the SIS Act.

The sole purpose test requires each trustee of a SMSF to ensure the SMSF is maintained solely for the benefit of the members for their retirement and is pivotal to the SMSF maintaining its compliance under the SIS Act and retaining the tax concessions available to superannuation funds.[10] Essentially, the sole purpose test requires the assets of the SMSF to be solely used for the purposes of providing retirement benefits for members; benefits for each member of the fund upon reaching 65 years of age and the provision of death benefits for the Legal Personal Representative or the member's dependants in the event of the member's death. The definition of dependant includes not only financial dependants but also the spouse and children of the deceased member even where they may not be a financial dependant. It also includes a person with whom the member has an interdependency relationship. If the sole purpose test is breached then not only may the SMSF be reported by an auditor as a non-complying fund but the trustees may also be subject to penalties.[11]

A non-complying fund is defined in s 995-1 of the *Income Tax Assessment* Act *1997* (Cth) as a superannuation fund that is not a complying fund. A SMSF is not a complying fund if it has received a notice from the ATO stating that it is a non-complying fund. The consequences of being a non-complying fund are that the SMSF loses access to the various tax concessions available to complying funds. Specifically, this means that the non-complying SMSF is subject to tax at 47% for the relevant financial year (not 15%), on not only on its earnings (assessable income less deductions) but also on unrealised capital gains based on the amount by which the market value of its total assets exceeds the amount of any un-deducted (non-

[8] APRA, *Quarterly Superannuation Performance* (interim edition) September 2014 (issued 20 November 2014) at page 9.

[9] Ibid.

[10] SMSFR 2008/2 explains in more detail and provides examples of what the Commissioner of Taxation considers to be the sole purpose test and also when it is likely to be contravened. Broadly the sole purpose test is taken to mean that the trustees of a SMSF are prohibited from maintaining an SMSF for purposes other than those set out in subs 62(1). The core purposes specified in that subsection essentially relate to providing retirement or death benefits for, or in relation to, SMSF members.

[11] In *DFC of T v Fitzgeralds and Anor* [2007] FCA 1602 civil penalties were imposed upon fund trustees for contravening the sole purpose test. Penalties were also imposed on trustees for breaching the sole purpose test in other more recent cases such as *Olesen v MacLeod* [2011] FCA 229 and also *Triway Superannuation Fund and Shail Superannuation Fund v FC of T* [2011] AATA 940.

concessional) contributions. There are further implications of being declared a non-complying fund such as the loss of access to the 33 1/3% Capital Gains Tax (CGT) discount and a loss of tax deductibility for member and employer contributions made to the fund.

The other major test that SMSFs are subject to is the in-house assets test. The purpose of this test is to ensure that the fund is not used for personal consumption purposes or to benefit members before these members are eligible to access their superannuation benefits.[12] The operation of both the sole purpose test and the in-house asset tests is discussed in more detail later on in this paper under the topic 'research study'.

4. RESEARCH STUDY

As there is a lack of available data on compliance issues facing self-managed superannuation funds a research study was arranged by the authors to consider a wide range of issues relating to the financial performance, corporate governance and fund compliance outcomes of Australian SMSFs. Specifically, with respect to fund compliance, the resulting draft questionnaire was targeted at capturing trustee knowledge and attitudes toward SMSF management along with trustee circumstances and overall fund compliance outcomes. The purpose of this was to investigate the potential relationships between SMSF compliance and various other fund and trustee characteristics, including but not limited to, the level of asset diversification, trustee over-confidence and trustee knowledge.

The data analysed for the research study in this paper originates from a survey administered to SMSF trustees in 2012. The survey was initially developed in consultation with the SMSF Association (previously known as SPAA). The final questionnaire was refined through a workshop held in late 2011 with a pilot group of trustees and via several interviews with professional SMSF advisors. The survey included a range of compliance related questions examining the financial investments and decisions of trustees, SIS Act knowledge and trustee satisfaction with various support professionals servicing the industry. The questions were specifically designed to encourage trustees of non-complying funds to respond, ensuring that we captured variation across funds, trustees and their corresponding compliance outcomes.

In order to further ensure a viable response rate the survey was widely distributed. The questionnaire was made available online through the Qualtrics® research platform allowing us to access responses from trustees across Australia. The survey was also publicised through a number of media outlets including *The Australian Financial Review*, and by the SMSF Association to its members. Various incentives were offered to participants including guaranteed gift cards and prize draw entries for the successful completion of the survey. The survey was further separately co-branded with two of the largest SMSF service providers, *SuperConcepts* and *SuperGuardian*, to be independently and privately advertised to their members. The survey was open for six months, closing at the end of June 2012. Of 595 attempting

[12] Superannuation benefits may only be accessed after a member has met a condition of release as defined in the various SIS Regulations such as in Parts 1A and 6 in for example reg 1.06 (regarding pensions) and reg 6.17 (on restriction on payment).

respondents 321 were able to provide complete answers to the full questionnaire, with 93% completing the survey on the same day.

The full survey comprised 20 questions with 96 individual inputs throughout. A total of 23 of these distinct inputs were used in this paper. These included one Likert question with seven categories, five numerical questions requiring the investor to consult their financial reports, nine dummy and three count variables on fund and trustee demographics, and five test questions examining the SIS Act understanding and knowledge of trustees.[13]

We measured SIS Act literacy through five questions relating to what SMSFs are permitted to do in Australia. We discuss the main rules governing the compliance of SMSFs in Australia elsewhere in this paper. The final set of questions was chosen from a much larger set of possible questions, all specific to the SIS Act. The questions were carefully designed to be of varying difficulty through several pilot studies which were assisted by professional advisors and the SMSF Association. They concurrently covered aspects of regulatory knowledge and financial understanding and formed the basis of both our SIS Act literacy and overconfidence measures.[14]

The **first question** of the survey tested trustee knowledge on the use of leverage and the borrowing restrictions set out in s 67 of the SIS Act to fund asset purchases. Trustees were asked if their SMSF can 'Borrow money from a bank to buy residential property for purely investment purposes that [they] have never owned' while remaining compliant with the SIS Act and regulations.

This question sought to examine understanding of this compliance issue implicitly assuming that it is similar to broader regulations imposed on other superannuation fund types, which are also limited in their usage of debt for the purpose of purchasing assets.[15] In compliance terms this issue focused on the question of whether an SMSF can borrow and also what affect the level of borrowing has on compliance. Prior to 24 September 2007 regulated superannuation funds were not permitted to borrow other than in very narrow circumstances and only for a temporary purpose.[16] However, with amendments made in September 2007, superannuation fund trustees could borrow money on a limited recourse basis providing certain conditions were met.[17] However, due to prudential concerns about the use of limited recourse borrowing arrangements, particularly with respect to instalment warrants, and the subsequent risks SMSFs were exposed to, this provision was repealed and replaced with ss 67A and 67B with effect from 1 July 2010.[18] Borrowing which meets the

[13] The questionnaire is available upon request.

[14] Table 2 provides a list of the variables, their derivation and the five specific questions which form the basis of our SIS Act literacy and overconfidence measures.

[15] We acknowledge recent legislative changes relating to limited recourse borrowing arrangements (discussed elsewhere in this paper) which were not in place and therefore not considered at the time of this study. This remains a potential avenue for future research on SMSF compliance.

[16] Section 67 of the SIS Act.

[17] Subsection 67(4A) of the SIS Act.

[18] The amendments were introduced to reduce the risks for superannuation funds investing in limited recourse borrowing arrangements such as instalment warrants and this specific risk was outlined in para. 1.1 of the Explanatory Memorandum to the Superannuation Industry (Supervision) Amendment Bill 2010 (Cth).

requirements of these new sections is referred to by superannuation industry experts as a 'complying loan'.[19]

On 29 July 2010 the ATO released a general guidance document, *Limited recourse borrowing arrangements by self-managed superannuation funds—questions and answers*, in response to the aforementioned July amendments on issues such as whether improvements materially alter the character of the original asset and so create a replacement asset for the purposes of s 67A of the SIS Act.[20]

The **second question** of the survey concerned the types of transactions which are permitted between a trustee and their fund. This is quite a complicated issue requiring trustees to understand a range of SIS Act regulations, including on arm's length transacting, the sole purpose test and restrictions on acquiring and holding in-house assets. A SMSF must keep the assets and money of the fund separate from the members[21] and an SMSF cannot lend money to a member or provide any financial assistance to a member.[22] SMSFR 2008/1 indicates what the ATO's view is on what constitutes providing financial assistance. Section 66 of the SIS Act provides that, with some exceptions, an SMSF cannot acquire assets from related parties.[23]

In the **third question** of the survey trustees were asked to demonstrate their understanding with regard to the types of assets which can be held within their portfolios. While there are no restrictions placed on investing in most of the major asset classes, in order to minimise risk and maximise returns, trustees should understand asset valuation techniques for unlisted assets as well as portfolio allocation and weighting strategies. This question also raised the compliance issue related to understanding the in-house asset allocation rules.

5. IN-HOUSE ASSET ALLOCATION TEST/RULES

The in-house asset allocation rules require that the fund hold no more than 5% of the market value of all its assets as in-house assets.[24] In-house assets are assets such as loans, or an investment, in a related party or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party.[25] A 'related party' means a member or a standard employer-sponsor of a fund and their associates.[26] The rules regarding in-house assets are quite complex and a breach can

[19] The term 'complying loan' is an industry term describing limited recourse borrowing arrangements that meet the requirements of ss 67A and 67B. The term was first identified as used by Daniel Jenkinson in his article 'Self-managed superannuation funds and real property—changes to the borrowing rules' (2011) 45(9) *Taxation in Australia*, at 527. Subsection 67(4A) of the SIS Act was repealed with effect from 7 July 2010 with the effect that the requirements of this former section are now referred to as 'instalment warrant' borrowing arrangements.

[20] For further discussion on the effect of the ATO's guidance document please refer to Jenkinson, note 19 above, 527–533.

[21] Section 52 of the SIS Act.

[22] Section 65 of the SIS Act.

[23] The exceptions contained in s 66 of the SIS Act 1993 provide that a SMSF can acquire assets from members where those assets are business real property or listed securities acquired at market value. SMSFR 2009/1 provides more clarification of when an asset is business real property.

[24] Sections 82–85 of the SIS Act.

[25] Section 71 of the SIS Act.

[26] SIS Regulations 1994, reg 13.22C.

also result in the superannuation fund being reported, potentially endangering the finds's complying fund status and therefore entitlement to the various tax concessions available only to complying superannuation funds.[27]

SMSF trustees are required to formulate and regularly review as well as give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the risk profile of the fund; the composition of the fund's assets including the holding of any in-house assets; the liquidity of the entity's investments; the ability of the SMSF to discharge its liabilities; and whether the trustees should hold a contract of insurance over any member or members.[28]

A case where the in-house asset restriction was breached was the case of *Deputy Commissioner of Taxation v Lyons*.[29] The case involved the trustee (Mr Lyons) of a SMSF lending money (about $190,000) through six loans to Mr and Mrs Lyons to help them with their struggling retail business. These loans were made just one month after the SMSF was established. None of these loans were ever repaid with the result that the fund had no assets. The Federal Court (Bennett J) ruled that the trustee breached the in-house asset rule (and the sole purpose test) with the result that the fund was declared non-compliant (the ATO having made this decision in 2012). Mr Lyons was further fined $32,500 and ordered to pay legal costs to the Commissioner of Taxation of $5,000.

The **fourth question** of the survey covered the extent to which fund assets could be used for private purposes before the member is of retirement age. SIS Act regulations only allow for a narrow range of specialised exemptions allowing early access to fund assets before retirement age and trustees are expected to be knowledgeable of these exemptions and timing restrictions under the Act. This fourth survey question therefore explored compliance issues related to the fund being held for the sole purpose of financing the retirement of its members.

6. SOLE PURPOSE TEST

The sole purpose test[30] provides that the fund be used solely for the provision of retirement benefits to the members or to provide benefits to each member of the fund on the member reaching the age 65 or to provide benefits for the Legal Personal Representative or the member's dependants[31] in the event of the member's death. The test therefore ensures that the assets held by a SMSF are maintained for the sole purpose of funding the retirement benefits of its members. However, the trustee of a SMSF is allowed to maintain the fund for other purposes (not specifically for the purpose of retirement benefits or the other grounds for paying benefits noted above). These ancillary purposes are recognised whenever a member meets a condition of release, such as termination of employment with an employer or associate who had

[27] As occurred in the case of *Re QX971 v APRA* 99 ESL 1.

[28] The requirement to set out and maintain and review an investment strategy is set out in SIS Regulations 1994, reg 4.09.

[29] *Deputy Commissioner of Taxation v Lyons* [2014] FCA 1353.

[30] The sole purpose test is set out in s 62 of the SIS Act.

[31] The term dependant includes not only a financial dependant but also the spouse or children of the deceased member even where the spouse and children are not financially dependant. It also includes a person with whom the member has an interdependency relationship.

contributed to the fund, thereby allowing the otherwise early payment of benefits to a member. This includes provision of benefits to a member where the member terminates employment as a consequence of ill-health.[32]

Paragraph 5 of SMSFR 2008/2 indicates the ATO approach to the sole purpose test and states that 'determining the purpose for which an SMSF is being maintained requires a survey of all the events and circumstances relating to the SMSF's maintenance. This enables an objective assessment of whether the SMSF is being maintained for any purposes other than those specified by s 62(1).' Superannuation tax expert, Bryce Figot, has concluded that the 'sole purpose test' is likely to be passed whenever the trustees are dealing with any transaction at 'arm's length'.[33]

7. CASES ON SMSFS AND THE SOLE PURPOSE TEST

The *Swiss Chalet* case[34] is the most obvious example of a case where a fund was found to have failed the sole purpose test. In this case the fund had purchased shares which enabled access to a golf club for one of the members in clear breach of the sole purpose test which requires that the fund assets be maintained for the sole purpose of providing for the retirement of the members.

More recently, the AAT has stated in *Montgomery Wools* that 'whether a fund complies with the sole purpose test will depend upon the facts of each case and will be assessed by objective facts, not the subjective views of trustees or, in the case of corporate trustees, the directors'.[35]

The very recent decision in *Deputy Commissioner of Taxation (Superannuation) v Graham Family Superannuation*[36] seems to confirm the views of Figot noted earlier in this paper in that Buchanan J emphasised that the sole purpose test was contravened in the case (where the SMSF rented residential property it owned to their son who did not pay any rent at all for its use) as the SMSF provided 'rental accommodation on non-arm's length terms (to the son)'.

The case of *Pabian Park Pty Ltd Superannuation Benefits Fund and FCT*[37] showed that in order to avoid being declared a non-complying fund and all the negative implications and tax consequences that would attach to the trustees of an SMSF,[38] the

[32] SIS Regulations 1994—reg 1.06(9A) deals with the grounds under which benefit payments can be made and reg 6.17 sets out the grounds under which a member may meet a condition of release.

[33] B Figot, 'The Sole Purpose Test- a new way to answer an old problem' (2013) *Professional Planner*, November, 39.

[34] *AAT Case 43/95; No 10,301* (1995) 95 ATC 374.

[35] *Montgomery Wools Pty Ltd and FCT* [2012] AATA 61.

[36] [2014] FCA 1101.

[37] [2012] AATA 375 at [72].

[38] As discussed earlier but also including the loss of the various tax concessions available only to complying superannuation funds. These losses would include such outcomes as a higher tax rate (47% in 2014/15 rather than the 15% rate) and the loss of the 33 1/3rd CGT discount. In addition, member contributions to a non-complying superannuation fund are not tax deductible and any employer contributions would not satisfy the employer's obligations for superannuation guarantee purposes and also, amongst other things, a non-complying superannuation fund cannot deduct current and prior year losses.

trustees should adopt a proactive approach to rectify contraventions by offering enforceable undertakings or agreeing to wind up the fund.

Consistent with other recent cases was the decision that failure to adopt a proactive approach is likely to increase the risk of a notice of non-compliance being issued and will also be a factor in considering whether the notice of non-compliance be set aside or revoked in any subsequent review proceeding.[39]

Re The Trustee for the R Ali Superannuation Fund and FCT[40] (*Ali case*) also demonstrated the need for proactive action on the part of SMSF trustees. Without this proactive action by the trustees of the SMSF to quickly rectify any contraventions and put in place procedures to ensure ongoing compliance with the superannuation legislation and ensuring there is written documentation to support the arm's length nature of the transactions with related parties, then it is likely the SMSF will be issued with a non-compliance notice under s 40 of the SIS Act.

The *Ali case* involved a number of serious breaches of the SIS Act such as the sole purpose test under s 62; the prohibition against giving financial assistance to a member under s 65 and the arm's length test under s 109. The case facts involved one of the trustees using all of the SMSF assets to give a loan to a related party that never paid any interest or indeed repaid any of the principal of the loan. The breaches in the *Ali case* were deemed very serious: (1) as they were carried out by someone who was a tax professional and so should have known better, (2) because they also exposed all of the fund's assets to risk of a type not permitted, and (3) were multiple in nature, attempted to be disguised and were only corrected after the Commissioner's audit activities commenced.

The **fifth and final** question in the survey again considered permissible investment types. The focus here was on the use of invested funds and in particular on understanding the sole purpose test for making investments or purchasing assets. Trustees of funds that have been found to have contravened any of the regulatory requirements (as reviewed in the five survey questions) can be charged with significant financial penalties.

8. CONSEQUENCES FOR NON-COMPLIANCE

The SIS Act provides a number of mechanisms, depending upon a number of factors such as the seriousness of the contravention, the attitude of the trustee to compliance generally and the ability to restore the SMSF to the position it would have been in but for the contravention, to address SMSF contraventions and breaches of the regulatory provisions.

[39] *Montgomery Wools Pty Ltd and FCT* [2012] AATA 61 at [126]; [140]–[141] and also *Re JNVQ and FCT* [2009] AATA 522.

[40] [2012] AATA 44.

Where there has been a contravention of the SIS Act the ATO may:

1. Accept an enforceable undertaking from the trustees to rectify the contravention;[41]
2. Seek civil or criminal penalties against the trustee;[42]
3. Disqualify individuals from acting as trustees;[43]
4. Suspend or remove a trustee of the superannuation fund;[44] or
5. Make the fund a non-complying fund by giving the fund a notice of non-compliance.[45]

The civil penalty provisions in the SIS Act include provisions which prohibit:

1. Making loans to or providing financial assistance to members;[46]
2. Acquiring assets from related parties of the SMSF (some limited exceptions);[47]
3. Borrowing money (subject to a specified limited recourse borrowing rule);[48]
4. Using the SMSF assets to benefit members before their retirement;[49]
5. Entering into non-arm's length investments unless both parties are dealing with each other at arm's length with respect to the transaction or if the parties are not dealing at arm's length but the terms and conditions are no more favourable than would be expected had the parties been dealing with each other at arm's length.[50]

Any intentional or reckless refusal or failure to comply with the civil penalty provisions is also an offence.[51] Reviewing the statistics reveals that the most commonly reported contravention is an entry into a loan with, or providing financial assistance to, a member.[52] Accordingly the ATO announced that for the 2012–13 financial year it was going to focus its SMSF audit activities on suspected arrangements that entered into non-arm's length investments and allowed for the early

[41] Section 262A of the SIS Act.
[42] Part 21 of the SIS Act.
[43] Section 126A of the SIS Act.
[44] Section 133 of the SIS Act.
[45] Section 40(1) SIS Act.
[46] Section 65 SIS Act.
[47] Section 66 of the SIS Act.
[48] Section 67 of the SIS Act.
[49] Section 62 of the SIS Act.
[50] Section 109 of the SIS Act.
[51] Section 285 of the SIS Act.
[52] M Bishop and R Jeremiah, 'SMSFs- responding to non-compliance warnings and notices' (2012) 47(3) *Taxation in Australia* at 163, quoting from the published ATO reported contraventions for the period 2005 to 30 June 2011 in the Australian Taxation Office, *Self-managed superannuation funds: a statistical overview 2009–10*, April 2012 at 36.

release of assets.[53] The ATO has also warned that late lodgement or non-lodgement of income tax returns by SMSFs will likely trigger an SMSF to be audited.[54]

A review of recent ATO annual reports reveals that the number of funds that had enforceable undertakings increased from 2010, when only 94 funds entered into enforceable undertakings, to 2014 where 329 funds entered into enforceable undertakings.[55]

9. NON-COMPLIANCE NOTICES

Subsection 42A(5) of the SIS Act confers on the ATO a discretion to issue a notice of compliance to an SMSF which has contravened one or more of the regulatory provisions of the SIS Act. Where the 42A(5) SIS Act discretion is not exercised in favour of the SMSF, the SMSF is issued with a non-complying fund notice and then loses the benefit of the concessional tax treatment afforded to SMSFs.

When determining whether to issue a notice of non-compliance to a SMSF the Commissioner must consider the taxation consequences of issuing such a notice; the seriousness of the contravention; and any other relevant circumstances.[56] The AAT has held that the subs 42A(5) discretion should be given 'a construction that allows the fullest relief which is open on a fair reading' of its terms.[57]

In addition, the Commissioner must have regard to considerations of unfairness but also apply the discretion 'in a manner consistent with the objects of the relevant Act'.[58]

The consequences of being declared a non-compliant fund are likely to be devastating to the trustees and members of the SMSF due to the loss of concessional tax treatment, taxation on all fund assets at their market value and taxation being payable at the highest tax rate applicable for that particular financial year. As a matter of administrative practice, the ATO therefore generally allows trustees the opportunity to either wind the fund up, roll it over to another independently managed superannuation fund, or enter into enforceable undertakings to rectify the defect discovered.[59]

In the 2010/11 financial year approximately 2% of SMSFs were reported to the ATO as having contravened requirements of the SIS Act or the SIS Regulations with the number of SMSFs issued with non-compliant fund notices being much lower.[60] The number of funds made non-compliant in 2014 was 129 which represented an increase from the 83 funds made non-compliant in 2012.[61]

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[53] Australian Taxation Office, *Compliance Program 2012–13*, July 2012 at 57.

[54] Ibid at 13.

[55] Australian Tax Office annual reports for 2010, 2011, 2012, 2013 and 2014.

[56] Section 42A(5) SIS Act.

[57] *The Trustee for the R Ali Superannuation Fund and FCT* [2012] AATA 44 at [64].

[58] *Re JNVQ and FCT* [2009] AATA 522 at [41].

[59] PS LA 2006/19 at paragraphs 16–17.

[60] Australian Tax Office, *Self-managed superannuation funds*, note 52 above.

[61] Australian Tax Office annual reports for 2012 and 2014.

10. REVIEW RIGHTS IF SMSF DECLARED NON-COMPLIANT

If a SMSF is declared non-compliant then the trustee has some review rights. These start with an internal review which allows the trustee 21 days, from the date of the non-compliance notice, to request a review of the non-compliance notice in writing setting out the reasons for the request.[62] The ATO then has 60 days from the date of such a request being made to reconsider the non-compliance notice decision and must provide the trustee reasons for confirming, revoking or varying the decision.[63]

If a decision is not made by the ATO within this 60 day period then any decision made by the ATO will be ineffective.[64] If the trustee is dissatisfied with the ATO's internal review decision then the trustee may apply to the AAT for an independent review of the decision.[65] This application must be made within 28 days of the receipt of the ATO review decision.[66] The AAT is the only independent forum for review of the decision to issue a non-compliance notice and it is not restricted to the reasons or grounds considered by the ATO.[67] There is no longer a right to privacy in AAT hearings unless the SMSF can demonstrate that some harm would result in their matter being heard in public.[68] An appeal can then be made from the decision of the AAT to the Federal Court but only on a question of law.[69]

11. DISQUALIFICATION OF TRUSTEES FROM MANAGING A SMSF

Another severe implication of a fund being declared non-compliant can also attach to the trustees of the fund who can then be declared disqualified. In the Commissioner of Taxation's annual report for 2013–14 585 persons were declared disqualified persons and this represented a significant increase on prior years.[70]

Being declared disqualified can have substantial adverse consequences quite apart from the person no longer being able to act as a trustee as there is also likely to be a substantial impact on the disqualified person's professional, business and personal reputation, more so due to the accessible impact of social media. This negative affect on reputation can cause a significant decline in future business income.

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[62] Section 344(1) and (2)–(4) of the SIS Act.

[63] Section 344(6) of the SIS Act.

[64] Section 344(5) of the SIS Act and *Re the Taxpayer and FCT* [2006] AATA 84.

[65] Section 344(8) of the SIS Act.

[66] Section 344(9) of the SIS Act and s 29 *Administrative Appeals Tribunal Act* 1975 (Cth) (AATA 1975).

[67] *Re Montgomery Wools Pty Ltd and FCT* [2012] AATA 61 at [60].

[68] Section 35(2) of the AATA 1975.

[69] Section 44 AATA 1975.

[70] For example in the 2010 tax year only 94 persons were declared disqualified; in 2011, 330 persons were declared disqualified; in 2012, 295 persons were declared disqualified whilst in in 2013, 440 persons were declared disqualified. This is in part explained by the greater ATO focus on promoters of illegal early access schemes.

12. RESULTS OF RESEARCH STUDY

We are of the view that SIS Act compliance and literacy are intrinsically linked with the long term financial goals of individual trustees and the wider industry objectives for compulsory and voluntary superannuation contributions as major pillars of the Australian retirement income system. Table 1 presents summary and comparative statistics of trustees who manage compliant funds (265 or 83% of our sample) versus those whose funds are non-compliant (56 or 17% of our sample).[71]

Table 1: Descriptive statistics showing mean values and mean difference tests

	Compliant	Non-Compliant	Difference## (C – NC)	Full Sample
Fund age (years)	12.59	11.48	1.11	12.40
Trustee age (years)	65.05	64.95	0.10	65.03
State (%)				
New South Wales	22.35	21.43	0.92	22.19
Queensland	12.88	17.86	–4.98	13.75
South Australia	14.02	21.43	–7.41	15.31
Victoria	43.94	32.14	11.80*	41.88
Other#	6.82	7.14	–0.32	6.87
Occupation (%)				
SMSF professional	18.26	5.66	–12.60**	15.81
Other professional	25.57	28.30	–2.73	26.10
Non professional	6.39	16.98	–10.59**	8.46
Retiree	49.77	49.06	0.71	49.63
Members per fund	1.95	1.86	0.09	1.93
Total assets (M AUD)	1.23	0.95	0.28*	1.18
SIS act literacy (correct responses)	2.66	2.11	0.55***	2.56
Overconfidence (%)	24.24	26.79	–2.55	24.69
Listed shares (K AUD)	691.51	405.44	286.07***	643.07
Other managed investments (K AUD)	17.73	56.55	–38.82	24.30
Cash and term deposits (K AUD)	295.52	363.65	–68.13	307.06
Loans (K AUD)	5.51	5.70	–0.19	5.54

Western Australia, Northern Territory, Tasmania and Australian Capital Territory.
Statistical significance for variation between groups is calculated based on the applicable two sample univariate test for differences in mean (assuming unequal variances) or proportion for each category.
Statistical significance is denoted as *** for $p < 0.01$; ** for $p < 0.05$; and * for $p < 0.10$.

We examined whether compliance outcomes were related to (1) experience with running an SMSF (fund age), (2) occupational knowledge of the SMSF sector (occupation), (3) the number of investors per fund (members) and (4) the dollar value of the fund (total assets). We also include in Table 1 the age of the responding trustee

[71] In determining whether a fund was non-compliant a question was asked in the survey as to 'whether the audit report for the fund was qualified for the year ended 30 June 2010?'

and the location of the fund by State. Of these demographic features, only fund size, occupation and location dummies seem to differentiate between funds that are compliant with their obligations under the SIS Act and those that are not. Specifically, compliant funds appear to have significantly larger total assets while also having a higher incidence of SMSF-related professionals among their trustees.

In terms of the above demographic features our sample was fairly representative of the general SMSF population at the time of this research.[72] The mean number of members per fund in the general population was 1.91, slightly below that of our sample (1.93 members). The general population mean investor age was between 55 and 64 years of age, also only marginally below that of our sample (65.03 years). Average fund size (by total assets) in the general population was approximately $917,000 as at June 2012.[73] This is below the sampled average of roughly $1.18m. Geographically, New South Wales and Victoria account for the largest proportion of SMSFs across Australia and these cohorts are also the largest constituents of our sample.

There is, however, an over-representation for South Australia, which is expected given the assistance we received from the SMSF Association (which is based in South Australia) in distributing the survey. The only other key deviation which exists between our sample and the general population of SMSFs relates to the compliance rate of constituent funds. The rate of non-compliant funds within the sector is quite small at approximately 2%.[74] The incidence of non-compliant funds in our sample is much higher (approximately 17%). This deviation is not surprising since the survey was geared toward capturing a larger number of non-complying funds in order to provide a sufficiently representative cohort for the statistical analysis which follows.

The described demographics constituted a set of control variables that were used in the subsequent regression analysis. The rationale for including both trustee- and fund-level demographics is to control for factors which can potentially influence the likelihoods of compliance and non-compliance respectively. Occupation and age measures were used to proxy for the experience level of the leading fund member.[75]

It was expected that fund size and fund age could also impact on compliance outcomes by influencing investment opportunities and through life-cycle effects.[76]

We further captured differences in the levels of SIS Act literacy and overconfidence with respect to SIS Act knowledge across the two groups. We expected that compliant funds were, *a priori*, likely to consist of trustees that are more knowledgeable (or literate) with regard to their regulatory and legal obligations under the SIS Act. If this was indeed the case, we should have seen a statistically significant difference in this level of technical knowledge between the two groups. Furthermore, we examined the attitude of SMSF trustees toward SIS Act compliance by comparing

[72] Australian Prudential Regulation Authority. 'Statistics: Annual Superannuation Bulletin – June 2012', Sydney (9 January 2013) and Australian Taxation Office. *Self-managed superannuation funds*, note 52 above.

[73] Australian Taxation Office. *Self-managed superannuation funds*, note 52 above.

[74] Australian Tax Office Annual Report for 2012.

[75] MCJ Van Rooij, A Lusardi and R.JM Alessie, 'Financial literacy and retirement planning in the Netherlands' (2011) 32(4) *Journal of Economic Psychology* 593–608.

[76] G Bhandari and R Deaves, 'Misinformed and Informed asset allocation decisions of self-directed retirement plan members'(2008) 29(4) *Journal of Economic Psychology* 473–490.

their self-assessed ability to ensure SIS Act compliance with their actual attainment on five key compliance-based questions with the results of these questions shown on the next few pages (also refer to the results for SIS Act literacy shown in Table 2). This provided a proxy measure for the level (or lack thereof) of trustee overconfidence in relation to compliance. Our expectation was that increasingly overconfident trustees would be associated with poorer compliance outcomes.

The results summarised in Table 1 suggest that the trustees of compliant SMSFs have a significantly higher rate of SIS Act knowledge than their counterparts who are managing non-compliant funds (SIS Act literacy = 0.55, $p < 0.01$).

Our measure of overconfidence is a dummy variable that compared a respondent's answer to each technical question with a corresponding supplementary question that asked how knowledgeable they think they were for each of the topics covered.

This is akin to treating overconfidence as a measure of the tendency to overestimate one's own knowledge as described by Lambert et al.[77]

The supplementary self-assessment questions corresponded directly to the theme of each SIS Act literacy question. That is, they were matched to consider the borrowing, related party transaction, asset investment, benefit payment and asset use permissions applicable to SMSFs under the SIS Act.

If an investor self-assesses their technical knowledge as being at least three Likert points (representing a 40% differential) better than their actual achievement (in the SIS Act literacy questions) we record a value of one by that fund and zero otherwise. This implies that the overconfidence level of any trustee can be reduced either through increases in their level of SIS Act knowledge or through reductions in their self-assessed proficiency with SIS Act compliance.

The Table 1 results also suggest that there are no statistically significant differences in compliance knowledge overconfidence between trustees of compliant and non-compliant SMSFs (Overconfidence = –2.55, $p > 0.10$).

Table 1 also shows differences in investment levels between the two cohorts for four asset classes.

Sampled trustees of compliant SMSFs appear to be slightly under-invested in: (1) cash and term deposits; (2) other managed investments; and (3) loans in comparison to their non-compliant counterparts, with none of these differences being statistically significant.

Compliant funds are however, significantly over-investing in Australian listed shares relative to non-compliant funds (difference in listed shares = 286.07, $p < 0.01$). This univariate result may also be an artefact of the dataset we are using since compliant funds are also on average much larger than non-compliant funds. Therefore, a more formal regression analysis was necessary to control for demographic differences

[77] J Lambert, V Bessière and G N'Goala, 'Does expertise influence the impact of overconfidence on judgment, valuation and investment decision?' (2012) 33(6) *Journal of Economic Psychology* 1115–1128.

between the cohorts while examining the relationships between SIS Act literacy, overconfidence, investment holdings and compliance outcomes.[78]

We ran probit regressions to evaluate the associations between SIS Act literacy, overconfidence and investment holdings, and compliance outcomes.

The probit model is most readily interpreted as a latent variable specification for binary data such that:

$$y_i^* = x_i' \beta + \varepsilon_i \qquad (1)$$

where x_i' is a transposed vector of independent variables (including controls), β is a vector of estimated coefficients and ε_i is a random disturbance term. The observed y_i are then determined from y_i^* using the following rule:

$$y_i = \begin{cases} 0 & if \quad y_i^* \leq 0 \\ 1 & if \quad y_i^* > 0 \end{cases} \qquad (2)$$

We made use of the demographic factors previously highlighted in Table 1 to generate a control variable set. The full variable list with descriptions is provided in Table 2.

[78] The results of this regression analysis are shown in Table 3.

Table 2: Variable list

Variable	Description/ Calculation
Study	
Compliance	Compliant fund dummy variable equal to 1 if the SMSF audit opinion is unqualified and 0 otherwise
SIS act literacy	Count variable ranging from 0 to 5 gauging trustee technical understanding based on correct/incorrect responses to five SIS compliance questions. Namely, can your SMSF do the following and still comply with the SIS Act and regulations: • Borrow money from a bank to buy a residential property for purely investment purposes that you have never owned? • Purchase business premises that you currently own? • Buy from you as a member, an unlisted managed investment that is widely held? • Pay a pension to a member who is over 55 but under 60 years of age, as part of a transition to retirement strategy? • Own a trading business?
Overconfidence	Dummy variable for trustee overconfidence with respect to compliance compares Likert self-assessment of regulatory and technical understanding to actual achievement in SIS Act literacy questions and is equal to 1 if the difference is greater than 3 Likert points and 0 otherwise
Listed shares	Quantitative variable (AUD) for direct investment in locally listed shares (Item H, Section H 2014 ATO SMSF annual return)
Other managed investments	Quantitative variable (AUD) for investment in local non-trust managed investments (Item D, Section H 2014 ATO SMSF annual return)
Cash and term deposits	Quantitative variable (AUD) for direct investments held in cash or term deposits (Item E, Section H 2014 ATO SMSF annual return)
Loans	Quantitative variable (AUD) for direct investment in loans (Item G, Section H 2014 ATO SMSF annual return)
Control	
Fund age	Count variable for fund age in whole years
Trustee age	Count variable for trustee age in whole years
SMSF professional	Dummy variable equal to 1 for professionals who are employed in SMSF-related fields (i.e. accountants, brokers, financial planners and auditors) and 0 otherwise
Non-professional	Dummy variable equal to 1 for non-professionals and 0 otherwise
Victoria	Dummy variable equal to 1 if the responding trustee lives in the state of Victoria and 0 otherwise
Members	Count variable ranging from 1 to 4 for the number of fund members
Total assets	Quantitative variable (AUD) for fund size in total assets

In order to link compliance outcomes with trustee features and demographics we show in Table 3 the output from two regressions where the probability of compliance is a function of SIS Act literacy, overconfidence, investment holdings and a number of controls.

Model 1[79] showed that trustees with increased levels of SIS Act literacy manage SMSFs which are associated with a greater likelihood of being compliant (SIS Act literacy = 0.1722, $p < 0.05$). This result is consistent with our prior expectations, suggesting that the level of SIS Act knowledge that trustees possess is linked with their eventual compliance outcomes.

However, we found no link between the level of compliance overconfidence exhibited by trustees and the compliance outcomes of their funds (overconfidence = 0.0501, $p > 0.10$). This result does not lend support to our expectation that increasingly overconfident trustees will be associated with SMSFs which have poorer compliance outcomes.

Model 2[80] demonstrated links between the investment holdings and compliance outcomes of SMSFs. The results suggest that as trustees increase their investment in Australian listed shares (0.0598, $p < 0.01$) and cash and term deposits (0.0525, $p < 0.10$), the probability of their SMSF being compliant also improves. Conversely, as trustees increase their investment in other managed investments (–0.0552, $p < 0.05$) and loans (–0.0812, $p < 0.10$), the probability of their SMSF being compliant deteriorates. Taken together, these findings put forward the idea that various investment classes may not be equal with respect to how they predispose trustees for their compliance obligations. It appears more likely that trustees will manage compliant funds if they follow the mainstream investment allocations to Australian shares and fixed income securities. Diversifying into less popular asset classes appears to be associated with increased probabilities of non-compliance. These results highlight a potentially fruitful avenue for future research—the interface between standard investment theory (favouring diversified holdings) and the legal and taxation requirements for regulatory compliance, which seem to be enhanced by reductions in the level of diversification for SMSFs.

Our controls also hold the right signs where they are significant.

Specifically, trustees who are employed in SMSF-related fields (e.g. employed as auditors or accountants or financial planners) are significantly more likely to be managing compliant SMSFs than other professionals, non-professionals and retirees. We found no other statistically significant demographic differences between trustees of compliant and non-compliant funds.

[79] Model 1 is represented by the first column of regression results shown in Table 3.

[80] Model 2 is represented by the second column of regression results shown in Table 3.

Table 3: SMSF compliance

	(1)	(2)
SIS Act literacy	0.1722**	
	(0.0747)	
Overconfidence[#]	0.0501	
	(0.2394)	
Log (listed shares)		0.0598***
		(0.0219)
Log (other managed investments)		–0.0552**
		(0.0258)
Log (cash and term deposits)		0.0525*
		(0.0297)
Log (loans)		–0.0812*
		(0.0487)
Constant	–1.6633	–1.0468
	(1.4517)	(1.5150)
Fund age	–0.0038	–0.0057
	(0.0136)	(0.0139)
Trustee age	0.0125	0.0049
	(0.0122)	(0.0127)
SMSF professional	0.7907**	0.9520**
	(0.3637)	(0.3934)
Non-professional	–0.4154	–0.2993
	(0.2994)	(0.3214)
Victoria	0.2188	0.1388
	(0.1998)	(0.2077)
Members	–0.0095	–0.0024
	(0.1586)	(0.1622)
Log (total assets)	0.0908	0.0329
	(0.1065)	(0.1177)
McFadden R^2	7.27%	12.34%
Likelihood ratio prob.	0.0312	0.0010

Table 3 results are generated from probit regressions where the dependent is the binary *Compliance* variable, equal to 1 if the SMSF audit opinion is unqualified and 0 if it is qualified.

As a robustness check for our measure of *overconfidence*, a second variable was created from the question '*Who is in the best position to prevent a possible breach of the SIS Act and regulations?*' Respondents were given a number of choices relating to using a stock broker, financial planner, accountant, auditor, lawyer, specialised SMSF administrator or themselves. Those respondents who selected themselves had to record the strength of their conviction, as measured on a scale from 1 to 7. This measure of confidence is related to a person's belief, whether correct or not, that they are best equipped to ensure SIS Act compliance relative to specialists in the field. We consider it a more direct measure of overconfidence when compared to the first measure capturing the differential between actual and perceived SIS Act literacy. Using trustee self-assessed ability to prevent a regulatory breach (measured as a Likert score ranging from 1 to 7) instead of *overconfidence* in model 1 above resulted in no changes in the significance or signs of any of the independent variables.

Statistical significance is denoted as *** for $p < 0.01$; ** for $p < 0.05$; and * for $p < 0.10$. Standard errors are in parentheses.

13. CONCLUSION

SMSFs continue to grow in number and size and so are becoming a larger and larger part of Australia's superannuation sector, already accounting for 30% of the sector by assets under management. One of the reasons for this growth is the freedom given to trustees to manage their own superannuation. Greater control, flexibility and choice are attractive but with this freedom comes increased responsibility. In the words of Bennett J 'responsible officers or trustees of self-managed superannuation funds are placed in a special position of trust because they can allocate a fund's assets without supervision and without seeking another's authority to do so'.[81]

This special positon of trust exposes trustees to many compliance issues. As discussed in this paper, these include the need to maintain fund assets for the sole purpose of providing retirement benefits to the members, as well as to satisfy the various other regulatory rules contained in the SIS Act and Regulations.

This paper has discussed some recent cases involving breaches of these compliance obligations and has therefore sought to highlight the significant challenges facing trustees managing SMSFs.

Statistical results of a research study into SMSF trustee compliance (as previously mentioned in this paper in terms of whether or not an auditor has reported a breach) revealed interesting insights on which trustees manage these challenges most effectively. We find that trustees with increased levels of SIS Act literacy manage SMSFs which are associated with a greater likelihood of being compliant. This result was even stronger for trustees who are employed in SMSF-related fields (such as in auditing, accounting or financial planning) who also appear significantly more likely to be managing compliant SMSFs than other professionals, non-professionals and retirees.

However, the survey also produced results which were not expected in that no statistically significant differences were observed between trustees of compliant and non-compliant SMSFs in terms of their compliance knowledge overconfidence.

The results of this survey also suggest that SMSFs, at least empirically, appear more likely to be compliant if they follow mainstream investment allocations to Australian shares and fixed income securities, and are correspondingly less likely to be compliant if they invest in international shares, loans and other managed investments. Our findings therefore reinforce the view that SMSFs are generally managed conservatively and counter to finance theory on diversification. Notably, the results seem to suggest that the need for compliance with regulatory requirements may be at the heart of why so many SMSFs are departing from standard finance theory and concentrating their investment allocations.

This last observation opens up potentially fruitful avenues for future research exploring the interface between standard investment theory (favouring diversified holdings) and the legal and taxation requirements for regulatory compliance.

[81] *Deputy Commissioner of Taxation v Lyons* [2014] FCA 1353 at para 35.

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Managing compliance risks of large businesses: A review of the underlying assumptions of co-operative compliance strategies

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Abstract

Large businesses play a vital role in the economy e.g. as large employers and investors. They are also important for the development of countries and for economic growth due to their (tax) contributions to the state budget. With growing budget deficits, numerous accounting scandals and public outrage about aggressive tax planning, corporate tax non-compliance is more than ever a serious issue for countries worldwide. In the last decade many tax authorities have developed so-called co-operative compliance strategies as preventive instruments to influence corporate tax behaviour. We conclude that the most important assumptions underlying co-operative compliance strategies are the contributions to taxpayer compliance by improving perceived procedural justice, reducing taxpayer uncertainty and improving tax risk management by taxpayers. These assumptions can draw on some theoretical substantiation, but none of them can claim a solid grounding from empirical evidence.

This article is part of a PhD research project in which corporate behaviour with regard to tax compliance is the subject of research.

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1. INTRODUCTION

Traditionally, tax authorities used so-called *deterrence strategies* to address tax compliance risks. These strategies are based upon the assumption that the threat of detection and punishment enforces compliance. Such strategies have several disadvantages. Deterrence activities are for instance costly and difficult (Smith & Stalans, 1991). The 'social costs' can be even higher if taxpayers respond by increasing efforts to avoid detection and punishment. Deterrence models are generally based upon the assumption that all non-compliance is intentional, as a result of conscious decisions by taxpayers. Non-compliant behaviour, however, can also be unintentional. Such unintentional non-compliance is unlikely to be (significantly) affected by deterrence activities (Smith & Kinsey, 1987). Also, deterrence models only focus on individuals and their cost-benefit analysis, while taxpayers also might be concerned about their social reputation, justice and fairness (Wenzel, 2002). And finally, deterrence activities can encourage resistance amongst taxpayers due to heavy-handed treatment and perceived breaches of procedural justice (Job, Stout & Smith, 2007).

Deterrence strategies alone are unable to efficiently attain or maintain desired compliance levels (especially given a finite level of resources). Therefore, tax authorities also use so-called *advise and persuade* strategies in a sound *compliance risk management* (CRM) strategy.[3] Advise and persuade strategies seek to prevent harm rather than punish it. They focus on cooperation between regulator, enforcement authority and addressee rather than seeking confrontation, and make use of conciliation rather than coercion (Gunningham, 2010).

One type of advise and persuade strategy is called *co-operative compliance*. In the last decade many tax authorities have implemented co-operative compliance approaches, generally aimed at large businesses (OECD, 2013). Co-operative compliance can be seen as a preventive instrument to influence corporate tax behaviour and thus address specific tax compliance risks of (large) businesses. Although co-operative compliance currently seems to be very common in managing compliance risks of large businesses, there is still hardly any research about the underlying assumptions of these strategies and only very little evidence of their added value (OECD, 2013).

The exploration of co-operative compliance strategies is relevant for many reasons. Given the political and public attention of corporate tax non-compliance, (potential) effects of new strategies such as co-operative compliance strategies will be monitored closely. Society will require tax authorities to demonstrate how co-operative compliance strategies add value to the effectiveness of the tax system (OECD, 2013). Besides, corporate tax non-compliance—in contrast to individual tax non-compliance—and regulatory strategies combatting corporate non-compliance, have received scarce scholarly attention in the field of tax compliance.[4] This is surprising

[3] CRM is a structured process for the systematic identification, assessment, ranking and treatment of tax compliance risks to stimulate compliance and prevent non-compliance based on the behaviour of taxpayers (OECD, 2004; EC, 2010).

[4] This is not entirely limited to *corporate* tax compliance. As noted by Richardson & Sawyer (2001, p. 249) the effect of contact with tax authorities on individual tax compliance has also received scarce attention in the time since Jackson & Milliron (1986). However, research in this area has increased since Richardson & Sawyer (e.g. Kastlunger, Kirchler, Mittone, & Pitters, 2009; Boylan, 2010).

given the economic importance of corporate taxes: in most countries the revenue of corporate taxes, such as corporate income tax, payroll taxes and value added tax, exceeds revenues from personal income tax.

Our study contributes to the literature by examining how co-operative compliance strategies are designed and how they are applied in practice. We distil the assumptions upon which co-operative compliance strategies seem to be based and discuss these assumptions within the context of (corporate) tax compliance research. The remainder of this paper is structured as follows. In section 2 we sketch the background for co-operative compliance strategies by discussing previous literature on corporate tax compliance. In section 3 we discuss the development of regulatory strategies and the origins of co-operative compliance. Subsequently, we provide an in-depth analysis of co-operative compliance strategies in section 4. Section 5 concludes this contribution.

2. FACTORS THAT INFLUENCE CORPORATE TAXPAYER BEHAVIOUR

Most literature on the subject of tax compliance is focused on the factors affecting *individual* tax compliance. It could be argued that individual and corporate tax compliance do not differ (much) since corporations, as fictitious entities, cannot decide to comply or not: their managers do (Joulfaian, 2000). These managers have, just like other individuals, their own attitude towards tax compliance and significantly affect *corporate* tax compliance by setting the 'tone at the top' with regard to the firm's tax activities (Koester, Shevlin, & Wangerin, 2014) and by setting and evaluating tax strategies (Olsen & Stekelberg, 2014). However, an important difference between individuals and organisations is that organisations work (by definition) in groups, usually with several actors holding varying degrees of corporate responsibility (Ariel, 2011). Increasingly, the literature acknowledges this difference and focuses specifically on *corporate* tax compliance. In this section we give a brief and selected overview of the work that we consider to be relevant within the context of corporate tax compliance.

2.1 The economic approach of corporate tax compliance

The standard economic model of tax compliance assumes that taxpayers are driven by rational, cost-benefit driven decisions. Within this context, *tax rates* play an important part in the willingness of corporate taxpayers to be compliant. Simply put, an increase in the tax rate makes it more profitable to evade taxes and therefore taxpayers are more willing to be non-compliant (Downs & Stetson, 2014). For managers of corporations there is another potential gain in being non-compliant. Minimising the tax burden of a corporation is in the interest of shareholders and, as their representatives, the board of directors. Therefore, to align incentives, the *compensation of managers* responsible for taxes may depend (inversely) on effective tax rates achieved (Crocker & Slemrod, 2005). However, this might encourage tax managers to seek less legal ways to lower effective tax rates and thus lower corporate tax compliance (Philips, 2003; Armstrong, Blouin, & Larcker, 2012; Rego & Wilson, 2012; Powers, Robinson, & Stomberg, 2013).

The potential costs of non-compliance are determined by the (perceived) *detection probability* and the perceived level of *penalties*. From empirical research it can be

concluded that increasing probabilities of detection and the level of penalties can deter taxpayers from being non-compliant. However, the effects of deterrence factors are generally shown to be relatively small (e.g. DeBacker, Heim, & Tran, 2015). For corporations, *book-tax conformity* is an important aspect of the detection probability. Book-tax conformity refers to the degree to which accounting and tax regulations are aligned. A legal framework with high book-tax conformity reduces the extent to which firms can reduce taxable income while raising book income, because reporting book-tax differences in such a setting signals non-compliance. Therefore, a high degree of book-tax conformity increases corporate tax compliance (Mills, 1996, 1998; Hung Chan, Lin, & Mo, 2010; Lee & Swenson, 2012; Tang, 2014).

Whether a taxpayer is sufficiently tolerant of the risks involved is not only determined by the perceived risks, but also by the '*risk appetite'* (or the level of risk one is prepared to accept). Taxpayers can have different risk appetites (Skinner & Slemrod, 1985). The risk appetite of taxpayers often is an important factor in theoretical approaches to tax compliance. Small changes in risk appetite can have profound effects on the predicted level of compliance. No empirical studies regarding the effect of risk appetite on corporate tax compliance are known to us. Intuitively, one might expect risk appetite plays an important role in corporate tax compliance. Many (larger) corporations have a formal corporate strategy, including a formalised risk appetite; risk appetite is an important part of all enterprise risk management models (e.g. COSO, 2011).

An assumption underlying economic compliance models (such as Allingham & Sandmo, 1972) is that humans make rational decisions. A large section of scholarly literature on tax compliance questions this rationality in regard to tax decisions. The rationality of taxpayers is, for example, affected by the level of *uncertainty*. Uncertainty affects tax compliance due to the fact that, in practice, taxpayers are unlikely to have precise information regarding audit probabilities, audit effectiveness (detection uncertainty), the level of penalties and the correct interpretation of tax law (or, in total, their actual tax liability). Humans generally avoid ambiguity; therefore it is likely that this uncertainty will affect tax compliance behaviour (Casey & Scholz, 1991; Taylor & Richardson, 2013). Uncertainty has various effects on tax compliance. For example, uncertainty regarding the correct tax position can lead to unconscious non-compliance but also to a situation in which a taxpayer is taking the most favourable tax position and awaits a challenge from the tax authority.

Complexity of the law can also limit the rationality of taxpayers and affects tax compliance in multiple ways. For example, complexity may lead to a lack of knowledge by taxpayers. The law and regulations become simply too complex and/or too much to understand in their entirety. This may lead to (unintentional) non-compliance. Also, complexity may lead to an increase in the opportunity to be non-compliant and thus increase non-compliance (Agha & Haughton, 1996). Finally, complexity could also lead to a rise in compliance costs. This rise may in turn lead to a decline in compliance, especially when taxpayers decide whether to be compliant based upon a cost-benefit analysis (McKerchar, 2002; Eichfelder & Kegels, 2014). However, complexity of tax law, which for a long time (e.g. Vogel, 1974) has been thought to have a negative impact on tax compliance, seems very difficult to reduce (e.g. Cuccia & Carnes, 2001).

It is generally acknowledged that the standard economic model does not (fully) answer the question why people pay taxes. Tax compliance research shows that other—

psychological and sociological—considerations, such as norms, trust and fairness play an important role (Kirchler, 2007).

2.2 The role of norms, trust and fairness in corporate tax compliance

Personal norms, or a manager's own moral standards, are assumed to be an important determinant of corporate tax attitude (e.g. Law & Mills, 2014). Personal norms seem to affect tax compliance in multiple ways. They can, for example, add an extra deterrence effect of internal sanctions such as guilt or shame (Braithwaite, Murphy, & Reinhart, 2007). Personal norms also could make deterrence superfluous since taxpayers driven by these norms are motivated to comply irrespective of formal sanctions (Wenzel, 2007). If these taxpayers are audited, this could crowd out the intrinsic motivation of tax compliance (Gangl et al., 2013). Therefore, the experience of an audit (or a *prior audit*) might affect the willingness to comply. Recently there has been increasing scholarly attention for this predicted correlation between top management characteristics and corporate behaviour (e.g. Chyz, 2013; Olsen & Stekelberg, 2014; Chyz et al., 2014; Gaertner, 2014; Koester et al., 2014; Law & Mills, 2014). These studies consistently find that personal norms (i.e. top-management characteristics) have a significant influence on corporate tax behaviour.

Personal norms can be acquired through the internalization of *social norms* (Wenzel, 2004). Social norms can be seen as moral standards attributed to a reference group, for example, at the level of family and friends, occupation, ethnicity or country. Social norms affect tax compliance in a complex way and its influence can be relatively large (e.g. Bobek, Hageman, & Kelliher, 2013). Taxpayers generally overestimate the non-compliance of other taxpayers, which might negatively affect their own compliance (Wenzel, 2005). It might therefore be that social norms are an important factor explaining non-compliance behaviour. An important aspect of social norms for corporations are reputational concerns. Graham et al. (2014) found reputational concerns to be an important determinant of corporate tax planning.

The level of *trust* a taxpayer has in the government affects his willingness to pay taxes, as paying taxes can be seen as fulfilling an obligation towards the government. (Taylor, 2002). Legitimacy denotes, at the least, acceptance of the right of a government to rule and is an important aspect of trust in the government. The effect of legitimacy is an increased likelihood of compliance with governmental rules and regulations (Levi & Sacks, 2009). Legitimacy of the government is influenced by various factors, such as government activities (e.g. efficacy and efficiency of politicians) and political structure (e.g. direct versus indirect democracy). Empirical research shows a positive effect of trust in the government on corporate tax compliance (e.g. De Mello, 2009).

Regarding the tax system as a whole, *fairness* is the most important consideration for individual taxpayers (Kirchler, Hoelzl, & Wahl, 2008). Several fairness considerations have been found to be important factors affecting *individual* tax compliance. These are: 1) *distributive justice*, the feeling that society does not offer enough (tax funded) resources compared to the amount of taxes one must pay (Verboon & Van Dijke, 2007); 2) *horizontal equity*, the equal treatment of equally circumstanced taxpayers (Goetz, 1978); 3) *vertical equity*, the fairness of the relative tax burdens of different societal groups or strata (Wenzel, 2002); 4) *retributive justice*, the perception that the tax administration is fair in applying punishments when the rules are broken (Walsh, 2012); and 5) *procedural justice*, the perceived fairness of

the procedures involved in decision-making and the perceived treatment one receives from the decision-maker (Murphy, Tyler, & Curtis, 2009). Regarding corporate tax compliance, empirical research including equity considerations is extremely scarce.

Besides the above-discussed considerations, tax compliance research shows that in a corporate setting also specific corporate aspects, such as corporate governance, and other corporate characteristics could affect tax compliance.

2.3 The role of corporate (governance) characteristics

'*Corporate governance'* is a broad concept referring to the way corporations are directed and controlled (Jamali, Safieddine & Rabbath, 2008). Corporate governance characteristics can limit opportunities for managers to be non-compliant and increase the ability of a corporation to be compliant. For example, a greater proportion of non-executive directors on the board can lead to better monitoring of management, which increases corporate tax compliance (Lanis & Richardson, 2011; Taylor & Richardson, 2013; Richardson, Taylor & Lanis, 2013b).

The quality of internal control or *tax risk management* is also relevant in this context. Not all tax decisions, especially in complex organisations, are made by those who are (ultimately) responsible. Especially for VAT and payroll taxes, tax compliance can be dependent on internal procedures and collaboration between employees. In regard to these taxes, the strength of the so-called 'tax control framework' (which forms the basis of tax risk management) can affect corporate tax compliance, for example, in setting standard procedures and designing internal audits. However, empirical evidence of this role of tax control frameworks does not exist.

The use of *tax advisors* and *external auditors* can also be seen as corporate governance mechanisms. Tax advisors can have two opposing effects on tax compliance. They can help taxpayers exploit ambiguous features of the law, which contributes to greater non-compliance (Klepper & Nagin, 1989). Alternatively, they can contribute to compliance by enforcing unambiguous features of the law and by discouraging non-compliance through advising the taxpayer against reporting positions which are likely to be challenged by the tax authorities. External auditors also play a role in corporate tax compliance; higher audit quality is expected to positively affect corporate tax compliance. The presence of an external auditor functions as an extra control measure, which increases corporate tax compliance (Mahenthiran & Kasipillai, 2012). However, audit quality is, in turn, affected by the provision of tax advisory by an accounting firm (Habib, 2012).

Corporate taxpayer characteristics often do have an effect on tax compliance, but why this is so is rarely theorised (Eisenhauer, 2008). It seems likely that many taxpayer characteristics are an operationalisation of another determinant of tax compliance (e.g., in regard to individual tax compliance, age can be seen as an operationalisation of risk appetite).[5] *Profitability* and *ownership structure*, however, do seem to affect corporate tax compliance (McGuire, Omer & Wang, 2012; Badertscher, Katz & Rego, 2013). Regarding profitability, empirical research mainly finds a negative effect on corporate income tax compliance (Richardson, Taylor & Lanis, 2013a).

[5] See Jackson & Milliron (1986) and Richardson & Sawyer (2001) for a discussion on different types of taxpayer characteristics and their effect on individual tax compliance.

Ownership structures can be quite diverse. Therefore, research regarding this subject is just as diverse and has focused on ownership characteristics such as foreign, hedge fund and family ownership. The effect of foreign ownership can be related to different social norms affecting the willingness to comply (DeBacker et al., 2013) but also to foreign owners not having full control of the firm's operations, which affects the ability to be compliant (Joulfaian, 2000). Hedge funds are generally found to be less compliant since they will, generally speaking, try to increase firm value in a relatively short term. Decreasing tax compliance might in this case be an effective strategy (Cheng, et al., 2012). Family firms seem to be more compliant since they have greater reputation concern with protecting the family reputation (Chen et al., 2010).

2.4 Factors influencing corporate tax compliance

In this section we discuss the factors influencing corporate tax compliance. Table 1 presents an oversight of all determinants of corporate tax compliance discussed in relation to corporations.

Table 1: Factors influencing corporate tax compliance

Economic factors	**Sociological & Psychological factors**	**Corporate (governance) characteristics**
Tax rate	Personal norms	Board of directors composition
Manager compensation	Social norms	Tax risk management
Detection probability	Distributive justice	Tax advisors
Penalties	Horizontal equity	External auditors
Book-tax conformity	Vertical equity	Profitability
Risk appetite	Retributive justice	Ownership
Uncertainty	Procedural justice	
Complexity of the law	Trust	

It should be noted that there are many more factors, for example, relating to the economy or a culture of a country, that could influence the behaviour of taxpayers beyond the ones mentioned in this paper. These 'external' factors however are out of control for the tax authority. It should also be noted that not all factors have the same importance for corporate taxpayers and that they interact in influencing compliance behaviour amongst corporates.

3. EVOLUTION OF REGULATORY TAX STRATEGIES FOR LARGE BUSINESSES

Regulatory tax strategies for large business have changed significantly in recent years. Some insights from tax compliance literature, as discussed in the previous section, have found their way into the daily practices of tax authorities and influenced regulatory strategies (OECD, 2010a). Tax authorities for decades worked in the same way: they selected individual cases for auditing and handled these cases from a perspective of 'distrust'. These strategies are known as '*deterrence' strategies*. Within this context tax authorities and taxpayers often played 'hide and seek' in a tax

audit, for example, resulting in taxpayers disclosing no more information than strictly required according to the law. Tax audits are also time-consuming and not always effective, because they generally do not address the 'causes' of non-compliance and therefore do not 'solve the problem'.

The limitations of a regulatory strategy solely based on deterrence slowly became obvious amongst tax authorities (OECD, 2002). The insights from tax compliance literature led to the notion of *compliance risk management strategies*, as advocated by the OECD (OECD, 2004) and EU (EC, 2010), in which tax authorities combine various elements of regulatory strategies to manage tax compliance risks. In the words of former US president Theodore Roosevelt, tax authorities started to speak softly besides carrying a big stick. For example, tax authorities started experimenting with regulatory activities aimed at taxpayers' *willingness* to comply. These kind of regulatory activities were known as *advise and persuade* strategies. They were strategies that tried to improve voluntary compliance and were based upon cooperation.[6] Regulatory activities were to be based upon an understanding of compliance behaviour. Thus, rather than focusing on treating the symptoms of non-compliance, underlying determinants of non-compliance were addressed (OECD, 2004).

Simultaneously, important changes in the business environment occurred; rapid globalisation, internationalisation of businesses and a changing relationship between government and society (Van der Hel-Van Dijk & Van der Enden, 2011). The major stock market scandals involving companies including Enron, Worldcom, Ahold and Parmalat led to an increased focus on corporate governance (Committee Horizontal Monitoring Tax and Customs Administration, 2012). As a result, many countries introduced legislation and standards that now require large businesses to provide greater transparency, such as the Sarbanes-Oxley legislation in the US (OECD, 2013). The Netherlands saw the introduction of a corporate governance code known as the 'Code Tabaksblat' in 2004.

These developments, together with the increasing focus on advise and persuade strategies, led to the development of *co-operative compliance* strategies directed at large businesses. Co-operative compliance strategies are an example of an advise and persuade strategy (Gunningham, 2010). Several initiatives by individual tax authorities all directed at large businesses (OECD, 2007) have been implemented:

1. the American IRS initiated a *Compliance Assurance Process* (CAP) programme
2. the Netherlands Tax and Customs Administration (NTCA) initiated a *Horizontal Monitoring* (HM) programme
3. the Irish tax authorities initiated a *Co-operative Compliance* programme
4. the Australian Tax Office (ATO) initiated their *Forward Compliance Arrangement* (FCA)
5. Her Majesty's Revenue and Customs (HMRC) initiated the *Review of Links with Large Businesses* programme.

[6] An important influence on the development of advise and persuade strategies was the publication of the book *Responsive Regulation: transcending the deregulation debate* by Ayres & Braithwaite in 1992.

In 2007 the OECD labelled these approaches 'enhanced relationships' (OECD, 2007). Five pillars were seen as being central to these enhanced relationships, namely understanding based on commercial awareness, impartiality, proportionality, openness through disclosure and transparency, and responsiveness by revenue bodies, and disclosure and transparency by taxpayers in their dealings with revenue bodies (OECD, 2013).[7] As a foundation to these five pillars, the enhanced relationship is based on establishing and sustaining mutual trust between taxpayers and revenue bodies (OECD, 2008a).

Over the next few years more countries started such 'enhanced relationship' programmes. Examples include Austria, Canada, Denmark, Finland, France, Japan, New Zealand, Russia, Singapore, South Africa, Spain and Sweden (OECD, 2013). Based on these developments, the OECD's Forum on Tax Administration (FTA) prepared a new report in 2013 (OECD, 2013). One noticeable change in the 2013 report as compared to the 2007 and 2008a reports, is the use of the term *co-operative compliance*.[8] The motivation for this lies in the fact that the term enhanced relationships had connotations of inequality (possibly due to capture) in tax treatment (OECD, 2013). To prevent misunderstandings it was therefore decided to use the term co-operative compliance. This is in line with Scholz (1984) and the Irish co-operative compliance programme. While seemingly just a semantic discussion, the use of the term co-operative compliance reveals the underlying objective 'as it not only describes the process of co-operation but also demonstrates its goal as part of the revenue body's compliance risk management strategy: compliance leading to payment of the right amount of tax at the right time' (OECD, 2013, p. 14).

Notwithstanding this renaming, the principal characteristics of co-operative compliance have remained the same. Of these characteristics, openness (through disclosure and transparency) is specifically mentioned by the FTA as being very important (OECD, 2013). Because of this, the OECD (2013) summarises co-operative compliance strategies as *transparency in exchange for certainty*.[9]

As another important change, the 2013 report stresses the importance of a tax control framework (TCF). The 2008a OECD report briefly mentions that corporations make use of a TCF, but does not elaborate on what that consists of. The 2013 report, however, stresses the importance of the TCF. As the 2013 report puts it: 'Transparency in exchange for certainty cannot exist without disclosure of tax risks and the underlying [tax control] framework (…) provide assurance that these risks surface' (OECD, 2013, p. 57).

Co-operative compliance strategies seem currently to be very common in managing the compliance risks of large businesses. A recent survey among 24 member countries of the large business network of the OECD shows all of these countries developed and/or implemented—formally or informally—a form of cooperative compliance (OECD, 2013). Although co-operative compliance seems 'here to stay' as part of regulatory tax strategies, it is a broad concept that varies not only over time but also across countries. Besides, there is no empirical evidence regarding the added value of these approaches (OECD, 2013).

[7] See OECD (2007) for a discussion of these five pillars.

[8] Although the term co-operative compliance was also used in 2008 by the OECD (OECD, 2008b).

[9] Interestingly enough, this epitome does not (directly) mention the assumed objective of all tax authorities; maintaining and/or improving tax compliance.

4. AN ANALYSIS OF CO-OPERATIVE COMPLIANCE STRATEGIES

The OECD is a strong supporter of co-operative compliance as a strategy to improve corporate tax compliance. It has been a driving force behind the international development of co-operative compliance strategies (Colon & Swagerman, 2015). While co-operative compliance is a broad concept, OECD reports reflect the views and experiences of its member states and can be expected to represent the consensus on co-operative compliance thinking as it has actually been applied by tax authorities in the Western world.[10] In this section we identify the common denominators of these strategies, based on documentation from the OECD and from individual tax authorities.

4.1 Establishing a working relationship

Co-operative compliance strategies were introduced as 'enhanced relationships' (OECD, 2007). Ever since, building an effective working relationship with businesses has been a major objective of all co-operative compliance strategies.

There is a 'basic relationship' in any country between the tax authority and the taxpayer which is 'characterised by the parties interacting solely by reference to what each is legally required to do without any urging or persuasion from the other' (OECD, 2007, p. 1). As part of this basic relationship, many large business taxpayers focus on the legal requirements taking abusive or aggressive tax positions and awaiting a challenge from the tax authority (OECD, 2009a). This 'cat-and-mouse game' has resulted in long-running disputes, with high costs for both parties.

The enhanced relationship is meant as a move away from the basic relationship (OECD, 2007). Tax authorities try to establish a relationship with large business taxpayers based on trust and co-operation (OECD, 2013), in which both parties aim for an open dialogue instead of the cat-and-mouse game and look towards speedy resolution of issues instead of long-running tax disputes. Moving from a contentious relationship towards a relationship based on trust and co-operation is the starting point of all co-operative compliance strategies. For example, the goal of the Australian co-operative compliance strategy is 'to build enhanced positive relations with large business' (ANAO, 2014, p. 32). This is to be achieved through mutual respect and responsibility (Datt & Sawyer, 2011). As another example, the British co-operative compliance strategy is designed to promote a relationship based on trust and transparency (Freedman, Loomer & Vella, 2009). To enhance the relationship, there are several requirements of tax authorities and taxpayers.

4.2 Requirements of tax authorities

Mutual trust is key in improving the working relationship between tax authority and taxpayer. As the popular saying goes; trust is earned, not given. Trust can be established, but requires each party to behave in a way that is seen by the other parties as trustworthy (OECD, 2007, p. 15). To be perceived as being trustworthy, there are five requirements ('key pillars') regarding tax authorities. These key pillars are: commercial awareness, impartiality, proportionality, disclosure and transparency, and responsiveness (OECD, 2013). OECD member states that have initiated co-operative compliance programmes have found these pillars to be valid (OECD, 2013).

[10] See also Verbeten & Speklé (2014) in relation to New Public Management.

Two pillars are perceived as particularly important: impartiality and proportionality (OECD, 2007; 2008a; 2009b; 2013). Impartiality requires tax authorities to demonstrate consistency and objectivity (OECD, 2013). Proportionality requires tax authorities to take taxpayer characteristics into account when pursuing or not pursuing a line of inquiry (OECD, 2007). Proportionality also requires tax authorities to discuss the implications of decisions before taking them and, in general, behave in a way that is human (OECD, 2007). Based on these two key pillars and their requirements of tax authorities, taxpayers have a reasonable expectation that revenue bodies will act consistently, objectively and fairly (OECD, 2008a).

The other three pillars—commercial awareness, disclosure and transparency, and responsiveness—can all be seen as contributing to tax authorities acting consistently, objectively and fairly. Commercial awareness requires tax authorities to have a good understanding of the commercial drivers behind the transactions and activities undertaken by large corporate taxpayers (OECD, 2013). For example, the Irish tax authorities name their approach based on a better understanding of the business as an important benefit for taxpayers from their co-operative compliance programme.[11] As a result, tax authorities should be able to respond more fairly to certain tax positions taken by taxpayers. Disclosure and transparency require openness about why the tax authority perceives particular behaviour or tax positions to be a risk, why the tax authority has asked particular questions or is seeking particular information (OECD, 2009b). Such openness will improve the (perceived) objectivity and fairness of the treatment a taxpayer receives. For example, the NTCA (2013) emphasises the importance of transparency and actively discloses its treatment strategy of large business taxpayers. Responsiveness requires tax authorities to establish a fair and efficient decision-making process (OECD, 2009b).

According to the OECD (2013), tax authorities should make the first move to improve the working relationship. By giving taxpayers consistent, objective and fair treatment, it is expected that taxpayers will reciprocate with improving their own behaviour. This assumption can be directly linked to procedural justice, one of the determinants of corporate tax compliance as discussed in section 2. The term 'procedural justice' is used to describe the perceived treatment a taxpayer receives from the tax authority and the perceived fairness of procedures involved in decision-making (OECD, 2004). Fairness, in this context, relates to relational aspects such as feelings and status as well as instrumental aspects such as monetary and time costs of the procedure (Stalans & Lind, 1997). An important component of co-operative compliance strategies in general, and horizontal monitoring more specifically, is the presumed positive effect on procedural justice. While scarcely studied in the context of tax compliance, there is some evidence of this effect from another field of compliance research. Nielsen & Parker (2009) found that co-operative behaviour by the regulator breeds an accommodating, co-operative attitude on the part of the regulated in the context of the Australian Consumer and Competition Commission.

4.3 Requirements of taxpayers

In building an enhanced relationship, taxpayers are required to provide disclosure and transparency (OECD, 2008a). The concepts of disclosure and transparency are related yet distinct from each other. Disclosure requires taxpayers to agree to go beyond

[11] See: http://www.revenue.ie/en/business/running/large-businesses.html#section2, visited April 11, 2015.

compliance with their statutory reporting obligations and voluntarily report any information necessary for the tax authority to undertake a fully informed risk assessment (OECD, 2008a). This includes the disclosure of all issues that relate to tax positions that give rise to a possible material risk (OECD, 2007). It should also include any information necessary for tax authorities to make fully informed decisions regarding the tax position of taxpayers (OECD, 2008a). Transparency is the ongoing framework within which individual acts of disclosure take place (OECD, 2007). As such, transparency on part of taxpayers can be seen as an aspect of the required attitude of taxpayers within a co-operative compliance strategy.

Transparency as a required attitude of taxpayers is an explicit part of all co-operative compliance programmes. For example, the Irish tax authority requires commitment by business to being open as part of its co-operative compliance programme.[12] As another example, the American tax authority states that taxpayers should provide information and documentation proactively as part of its CAP programme.[13] Also, the British tax authority expects a taxpayer participating in its co-operative compliance programme to raise significant compliance issues, uncertainties and/or irregularities with HMRC in real time.[14] Finally, within the Dutch HM programme taxpayers are required to be transparent about their tax strategy and relevant tax issues (NTCA, 2013).

Adequate transparency and disclosure is dependent on a robust system of internal control (OECD, 2013). In other words, to be able to be fully transparent regarding tax risks it is necessary for a taxpayer to be in control regarding these risks. A Tax Control Framework (TCF) is the part of the internal control system that assures accuracy, timeliness and completeness of tax returns and disclosures made by a corporation. As a result, the improvement of tax control is an important condition of all co-operative compliance strategies. For some co-operative compliance strategies this improvement is promoted by having a good TCF ('*the taxpayer has good internal controls*') as a condition for participating in the programme (e.g. the US CAP).[15] For others, this improvement of the TCF is part of a co-operative compliance strategy in the form of an on-going process (e.g. the Dutch HM programme).

4.4 The aims of co-operative compliance strategies: taxpayers

For taxpayers, the enhanced relationship is a means having tax matters resolved quickly, quietly, fairly and with finality (OECD, 2007). Large taxpayers view the increase of certainty as one of the most important advantages of co-operative compliance (OECD, 2007; 2009b). Tax authorities can increase taxpayer certainty regarding their tax position by increasing taxpayer knowledge of the authorities' position on tax issues and by increasing taxpayer knowledge of the authorities' audit plan (OECD, 2009b).

[12] See: http://www.revenue.ie/en/business/running/large-businesses.html#section10, visited March 9, 2015.

[13] See: http://www.irs.gov/irm/part4/irm_04-051-008.html , visited March 9, 2015.

[14] See: http://www.hmrc.gov.uk/manuals/tcrmanual/TCRM1000.htm, visited March 8, 2015.

[15] See: http://www.irs.gov/irm/part4/irm_04-051-008.html#d0e281, visited April 11, 2015.

4.4.1 Interpretation of tax issues

Taxpayers might see potential for a significant difference of interpretation between them and the tax authority regarding certain tax issues (OECD, 2010b). If a taxpayer does not disclose uncertain tax positions, it is more difficult for the authorities to determine whether a transaction is potentially subject to dispute, due to the fact that they are less informed (Datt & Sawyer, 2011). A potential difference of opinion however, also could lead to uncertainty regarding tax issues for the taxpayer himself. As part of their co-operative compliance strategy, tax authorities provide taxpayers with the opportunity to gain certainty regarding specific tax issues (Datt & Sawyer, 2011). For example, the British tax authority 'will give binding rulings across all relevant taxes to businesses that provide clear plans for significant investment or corporate reconstruction; or a binding view of the tax consequences of significant commercial issues, pre or post-transaction, where there is legal uncertainty' (HMRC, 2007, p. 17). As another example, the Canadian tax authority provides 'a written statement (…) stating how [they] will interpret and apply specific provisions of existing Canadian income tax law to a definite transaction or transactions which the taxpayer is contemplating' (OECD, 2009b, p. 28).

4.4.2 The audit plan

Taxpayers face uncertainty regarding whether they have identified all 'tax issues'.[16] By performing an audit, a tax authority might detect transactions that were not identified by a taxpayer as a relevant tax issue while the tax authority might have a different opinion. Uncertainty might derive from a misjudgement of what the tax authority might define as a tax issue, a failure of the TCF in detecting all tax issues and/or unpredictable behaviour on part of the tax authority. Tax authorities can increase taxpayer certainty by sharing their audit plan.

As an example, the Irish tax authority states that audits will 'be signalled to the business as part of each year's overall risk management plan'.[17] As another example, for each taxpayer within the large business division, the NTCA draws up a so-called strategic supervision plan. This plan contains the selection of regulatory activities and the planning of these activities (NTCA, 2013). To increase predictability of its regulatory activities, the NTCA shares this supervision plan with taxpayers within horizontal monitoring after a compliance agreement has been concluded (NTCA, 2013). Through sharing the supervision plan, the NTCA aims at increasing taxpayer certainty (NTCA, 2013).

Tax authorities can also improve taxpayer certainty by providing information on tax issues and the audit plan at an earlier moment in time. As a result, and as part of their co-operative compliance strategy, tax authorities try to move from an examination of tax returns after filing to a real-time evaluation of risks and compliance issues to improve taxpayer certainty (OECD, 2009b). For example, taxpayers participating in the CAP programme of the American tax authority are able to achieve tax certainty sooner.[18] The OECD (2009b) describes several methods and programmes of

[16] Given the presumption that taxpayers aim for full disclosure and transparency. If not, this type of uncertainty might also relate to deliberately withheld tax issues.

[17] See: http://www.revenue.ie/en/business/running/large-businesses.html#section7 , visited December 31, 2014.

[18] http://www.irs.gov/irm/part4/irm_04-051-008.html , visited March 8, 2015.

participating countries in order to provide certainty to large taxpayers and address compliance on a real-time basis, such as forward compliance arrangements, advance rulings and advance pricing agreements.

According to the OECD (2009b) an increase of certainty is, in practice, indeed achieved through co-operative compliance strategies. For example, from the evaluation of the first pilot with 20 very large businesses it was concluded that HM did indeed lead to an increase of certainty (OECD, 2013). Also, Beck & Lisowsky (2014) found that the American CAP programme—a form of co-operative compliance—led to a significant reduction of taxpayer uncertainty.

Increasing certainty is the most important benefit for taxpayers of co-operative compliance strategies (Ventry, 2008). However, to receive this certainty from tax authorities, taxpayers need to be transparent and disclose all issues that relate to tax positions that give rise to a possible material risk. (OECD, 2007). Without this information tax authorities are unable to provide certainty. From the perspective of the taxpayer a co-operative compliance relationship can therefore be seen as a kind of transaction, in which transparency is exchanged for certainty.

4.5 The aims of co-operative compliance strategies: tax authorities

From the perspective of tax authorities, improving the working relationship with taxpayers is not an end in itself but a means of establishing the right amount of tax payable by taxpayers in a quick, fair and efficient manner (OECD, 2007). In other words, by implementing a co-operative compliance strategy tax authorities aim to influence and promote large taxpayer compliance (OECD, 2009b). For example, the Irish co-operative compliance programme is designed to provide greater levels of taxpayer compliance (OECD, 2007). As another example, the United States Government Accountability Office reports that anecdotal evidence indicates that the American CAP programme is effective in ensuring compliance (United States Government Accountability Office, 2013). The New Zealand tax authority also stated that encouraging large taxpayer compliance was the goal of their co-operative compliance pilot.[19] Based on early experiences of eight OECD member states, the OECD (2009b, p. 26) concluded:

> Building a new form of relationship with large business is one of the key strategies adopted by the participating countries to influence and promote large taxpayer compliance.

How a co-operative compliance strategy should contribute to increasing taxpayer compliance is seldom explicitly stated. However, the OECD provides some insight into how taxpayer compliance can be increased. Taxpayers who believe they have been, or will be, dealt with fairly by the tax authority are much more likely to comply with its requirements than those who believe the system is not fair (OECD, 2000; 2010b). In the words of the OECD (2014, p. 77): 'compliance, and by extension revenue, flows from taxpayers' belief in the willingness (trust) and ability (confidence) of the revenue body to conduct its business fairly and objectively'. Empirical evidence for this expectation is scarce, although some evidence can be found in other fields of compliance research. Regarding subsidiary top management

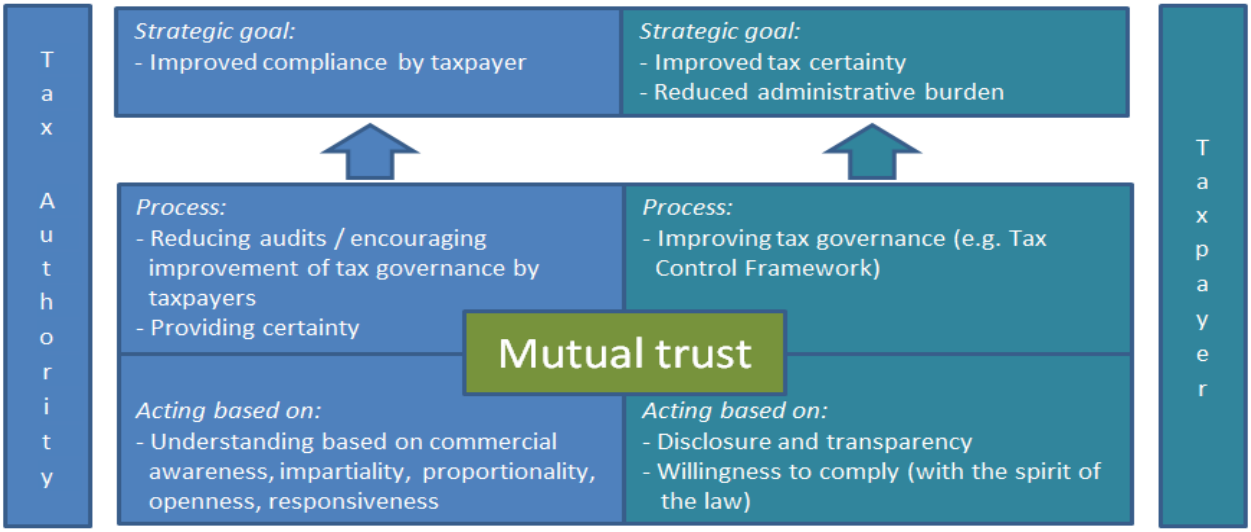
[19] http://www.ird.govt.nz/aboutir/reports/compliance-focus/compliance-focus-2011-12/confidence-certainty/focus-confidence-certainty.html, visited March 8, 2015.

compliance with multinational's corporate decisions, Kim & Mauborgne (1993) found a positive effect of procedural justice. Also, Makkai & Braithwaite (1996) and Braithwaite et al. (1994) found a positive effect of procedural justice on nursing home compliance. In regard to the presumed effect of an increase in procedural justice on corporate tax compliance, the OECD (2009b, p. 26) concluded, based on a survey amongst eight member states: 'improving and building a relationship based on transparency, trust, and mutual understanding would have a positive impact on large business compliance.' Also, a survey study by the Inland Revenue Authority of Singapore (IRAS) found that perceptions of fairness of the IRAS among taxpayers were directly related to tax compliance (OECD, 2010a).

4.6 The common denominators of co-operative compliance strategies

From the above, the common denominators of co-operative compliance strategies can be distilled. In Figure 1 we divide the common denominators of corporate compliance strategies into strategic goals, the actual process and the basic requirements in the area of behaviour for both the tax authority (left) and the taxpayer (right). In other words, we distinguish between *how* both parties should act, *what* they should do and *why* they do it. Establishing and sustaining mutual trust between taxpayers and revenue bodies is pictured centrally, since this is the foundation for the relationship between both parties.

Figure 1: The common denominators of co-operative compliance strategies (as compiled by the authors)



5. CONCLUSIONS AND DISCUSSION

Many countries currently are suffering from large budget deficits and are—at the same time—confronted with large revenue losses due to tax non-compliance (the so-called 'tax gap'). Auditing large businesses in a traditional way is not sufficient anymore to deal effectively and efficiently with compliance risks of large businesses. Since the beginning of this century tax authorities have been exploring the possibilities of overarching compliance risk management (CRM) strategies, in which elements of several regulatory strategies—such as co-operative compliance and deterrence

strategies—are combined. Within CRM, the application of the right type of approach for a certain taxpayer and at a certain time depends on an analysis of the taxpayer's behaviour. An improved understanding of taxpayer behaviour can therefore help tax authorities to make better decisions managing compliance risks of e.g. large businesses.

Before we discuss our conclusions further, a few caveats are necessarily in order. First, in this article we present an overview of the common denominators of co-operative compliance programmes, mainly based on OECD literature. In practice, there are many different applications of 'co-operative compliance thinking' that—in various degrees—differ from what we describe in this article. However, it must be noted that all applications do indeed share some basic principles, such as the willingness of most large business taxpayers to comply. Also, where possible, we supplemented our reasoning based on the OECD reports with examples from specific co-operative compliance strategies from individual countries. Second, there is a striking lack of empirical evidence regarding corporate tax compliance in general and co-operative compliance strategies specifically. All conclusions relating to co-operative compliance strategies are therefore tentative at best. It must be noted though that several OECD reports do provide some anecdotal evidence.

Co-operative compliance envisages an enhanced relationship between tax authorities and taxpayers (usually large businesses) in which both parties cooperate to effectively and efficiently maintain or improve tax compliance. To be able to measure the effects of corporate compliance strategies, one must understand the 'inner workings' of such regulatory instruments. In other words, the assumptions underlying these instruments must be made explicit. In this article we analysed co-operative compliance strategies and discussed the assumptions as they can be derived from several OECD reports and documentation of individual countries. These strategies and assumptions can be viewed from both the perspective of the tax authorities or the taxpayer.

Tax authorities are required to give taxpayers a consistent, objective and fair treatment. It is assumed that such a treatment increases taxpayer compliance. We link this to an improvement in perceived procedural justice. However, while there is substantive empirical evidence of a positive effect of procedural justice on individual tax compliance, there is no such evidence with regard to large business taxpayers. More broadly speaking, there is a lack of evidence regarding the effect of so-called advise and persuade strategies on compliance (Shapiro & Rabinowitz, 1997; Krawiec, 2003). Also, advise and persuade strategies are vulnerable to strategic behaviour of those not wanting to comply voluntarily (Voermans, 2013). However, though lacking empirical evidence, an econometric model developed by DeSimone, Sansing & Seidman (2013) shows that co-operative compliance strategies can be mutually beneficial.[20]

Within a co-operative compliance programme, taxpayers are required to provide disclosure and transparency. It is assumed that this will increase taxpayer certainty, since disclosure and transparency enable tax authorities to provide this certainty. The wish or need for certainty of taxpayers and the ability of tax authorities to provide certainty are therefore important prerequisites of a co-operative compliance strategy.

[20] There is some empirical evidence from other fields than tax compliance for the effectiveness of a cooperative compliance strategy, e.g. Earnhart & Glicksman (2015).

Tax risk management plays an important role within co-operative compliance strategies. It is assumed that improving the so-called tax control framework (TCF) can both enable taxpayers to disclose all relevant information on tax risks and increase actual compliance. The assumption that improving internal control frameworks, like a TCF, can improve compliance behaviour is, however, disputed. For example, Power (2009) argues that risk management frameworks might be more about creating organisational accountability than about actually managing risks. Thus, implementing and improving a TCF might just be a form of 'cosmetic compliance' (Krawiec, 2003). While both sides whether a TCF can be beneficial to compliance can be argued, it should be emphasised that empirical substantiation for both sides of the argument is lacking (Huisman & Beukelman, 2007).

We conclude that the most important assumptions underlying co-operative compliance strategies are the contributions to taxpayer compliance by improving *perceived procedural justice*, reducing *taxpayer uncertainty* and improving *tax risk management* by taxpayers. These assumptions can draw on some theoretical substantiation, but none of them can claim a solid grounding from empirical evidence. This emphasises the need for both effect measurement by tax authorities and scholarly (empirical) research. This lack of empirical, scholarly research seems to be an overarching characteristic of advise and persuade strategies. Further research should, therefore, focus on finding ways to empirically testing the assumptions of advise and persuade strategies in general and co-operative compliance strategies more specifically.

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Tax experts' opinion on the tax system in Slovenia[1]

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Abstract

Following the tax policy priorities put forward by the European Commission and taking into consideration the reduction of budget deficit, Slovenia made several changes in the tax system. In the paper, we present research results of experts' opinion about the tax system in Slovenia. The research results show the opinion on different statements connected with the country's tax policy. The strongest agreement was reached for the statement that administrative and compliance costs of taxation should be an important element of the tax policy. We also made binomial probit regressions in order to determine how economic views and values influence experts' opinion.

Key words: *Tax system, expert opinion, tax policy, Slovenia*

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1. INTRODUCTION

At the end of the year 2013 and the beginning of 2014, a survey about the Slovenian tax system was conducted among different experts in Slovenia. The survey followed the example of a 2013 survey conducted in the USA, which was carried out for the purpose of comparison with similar surveys in 1994 and 1934 (NTA, 2013; Lim et al., 2013; Slemrod, 1995) and a survey in Croatia (Šimović et al., 2013). The purpose of our research was to find out experts' opinion about the current tax system in Slovenia and whether it is in alignment with European Commission's proposals and with goals determined by the Slovenian government.

The growing economic crisis has resulted in a range of reforms, and the tax system is no exception. As part of the Europe 2020 Strategy, the European Commission has decided to report on and propose measures to increase economic growth using the Annual Growth Survey (European Commission, 2010). Consequently, at the end of 2012, the European Commission proposed that the following taxation measures be implemented in 2013: shifting the tax burden away from labour, broadening the tax bases, improving tax compliance and reducing company debts as a result of corporate income tax (European Commission, 2012). An overview of the reforms in the last three years shows that the majority of countries have made considerable efforts to prevent tax evasion; in order to stimulate economic growth, the EU Member States have decreased corporate income tax or adopted additional tax measures to promote scientific and research work, investments and entrepreneurship in general (Garnier et al., 2013). Special recommendations for Slovenia for the years 2011–2013 did not include measures in the field of taxation (Council of the European Union, 2013). Regardless of the recommendations for Slovenia, in the past three years, the country has begun to implement a number of changes, including in the field of taxation, which do not necessarily comply with the recommendations of the Annual Growth Survey 2013 (European Commission, 2012).

Our survey covers three sectors of experts: academic, private and government. We wanted to find out whether all three groups agree/disagree with the statements connected to the tax system and, consequently, with changes in the field of taxation, its influence on economic growth and recommendations of the EU. We used binominal probit regression to analyse the possible influence of economic views and values on attitudes on tax policy. The central thesis of this paper is that, despite the known theoretical assumptions on tax reforms that would promote economic growth, tax experts in Slovenia in general do not support such changes and are in favour of changes that are actually focused on fiscal consolidation.

The paper is structured as follows: after the introduction, a short comparison of the tax reforms in Slovenia is presented with measures adopted by other EU Member States. Afterwards, we present methodology of the research conducted among tax experts. The following sections present the research results and binomial probit regression. The paper concludes with final remarks.

2. SLOVENIAN TAX CHANGES AND COMPARISON WITH MEASURES ADOPTED IN OTHER EU MEMBER STATES

While there are a number of reasons for tax reforms, the reforms introduced in the past four years have undoubtedly been focused on the economic crisis. In most countries, the initial changes were unplanned and mainly concerned with increasing the budget. In Slovenia, several tax measures were introduced in 2010, mainly aimed at promoting and supporting the economy; however, these changes were replaced by a major adjustment in 2013, aimed at fiscal consolidation. Table 1 indicates some major changes during both periods.

Table 1: Tax changes in two periods during the crisis in Slovenia

	Tax changes in 2009–2012	**Tax changes in 2013–2015**
Corporate income tax	Plan to decrease tax rate from 20% to 15%	Decrease of tax rate stopped at 17%
		Increase of some tax reliefs
Tax on banks' balance sheet	Introduction of tax in 2011	Tax abolished in 2015
Personal income tax		Additional tax bracket with the tax rate of 50%
		Tax rate for the taxation of income using the schedular system* was increased from 20% to 25%
		Decrease or abolishment of some tax reliefs
	Flat rate system for small businesses introduced	Flat rate expenses increased
VAT		Increased tax rates
		Increase in the threshold for entry into VAT system

*interests, capital gains, dividends, and rent

Comparing those changes with those in other EU Member States, we found that Slovenia has adopted measures similar to most other countries. A review of the changes adopted in the tax legislation of the EU Member States shows some measures in a similar direction (more details in Klun & Jovanović, 2012). A more detailed review (see Table 2) of the changes in each Member State in 2012 and 2013 shows that the majority of measures do not conform with the recommendations included in the Annual Growth Survey 2013 (European Commission, 2012).

Table 2: Tax changes in the EU Member States in the period 2012–2013

Tax	Number of the Member States that increased tax rates	Number of the Member States that decreased tax rates
VAT	9	3
Excise duties	19	0
Environmental taxes	11	3
Corporate income tax	6	6
Personal income tax	9	2
Property taxation	7	3

*Source: Garnier et al., 2013

Additionally to presented changes in tax rates, 16 Member States adopted measures lowering the corporate income tax base (e.g. by increasing tax reliefs or introducing special arrangements). It is also interesting to note that half of all the EU Member States introduced reforms concerning the taxation of property (Garnier et al., 2013).

3. SURVEY ON THE OPINION OF TAX EXPERTS ON THE TAX SYSTEM IN SLOVENIA

3.1 Methodology and survey

During the preparation of the survey, we followed the example of a 2013 survey conducted in the USA, which was carried out for the purpose of comparison with similar surveys in 1994 and 1934 (NTA, 2013; Lim et al., 2013; Slemrod, 1995), and a survey in Croatia (Šimović et al., 2013). There are several other surveys adopted by researchers based on general opinions or on selected issues in taxation (i.e. Behrens, 1973; Dornstein, 1987; Ashworth & Heyndels, 1997; Kirchler, 1999; Petersen et al., 2000; McGowan, 2000; Murphy, 2004; McCabe & Stream, 2006; Hammar et al., 2008; Campbell, 2009; Ventry, 2011; Hulse, 2012; Sanandaji & Wallace, 2014; The Free Library, 2014; Borrego et al., 2015).

As mentioned before, we have chosen a broad survey on several tax issues based on surveys already used in the USA and Croatia. Those surveys were adapted to Slovenia's tax system and include both identical and partially different statements connected to tax legislation and the participants' opinions. There is a total of 92 statements, which the participants evaluated with five different grades. The 92 survey questions could be divided into different tax groups: property taxation, personal income tax, corporate income tax, VAT, excise duties, social contributions, general tax issues and values, and other taxation. The survey concluded with questions about the participants' age, education and area of work. It was carried out in a population that is professionally involved with the tax system. In terms of timing, the survey was carried out between December of 2013 and April of 2014 among three groups: employees at the Ministry of Finance (including the Tax Administration and Customs Administration), tax consultants and academics in the field of finance and economics. The survey was sent to the academics and tax consultants using email addresses available on the websites of various faculties and institutes, or in the business register. It was sent to a total of 53 academics and 300 tax consultants. Employees at the

Ministry of Finance were forwarded the survey through the managing director of Tax Administration, the Customs Administration head office and the Ministry of Finance. The total number of recipients is therefore unknown, as it depends on how many heads of departments forwarded the survey, but the response in this group was considerable, with 101 employees filling in the survey. The response rate was the poorest in the private sector (only 18%), and somewhat better among academics (22.6%). In total, 169 individuals responded to the survey. The structure of the respondents is presented below.

Table 3: Respondent structure

	N	%
The academic community (universities, institutes)	13	7.7
The general government sector	101	59.8
The private sector	55	32.5
Total	**169**	**100.0**

3.2 Degree of consensus

The Slovenian survey was conducted similarly to the Croatian survey, using five-level Likert items,[4] which differs from the NTA survey that only allowed yes/no answers. To make a better comparison, we decided to group the answers 'strongly agree' and 'agree' into 'yes', while the answers under 'no' entail 'disagree' and 'strongly disagree' (neutral responses are excluded). According to the NTA survey, at least 61% positive or negative answers are taken as the threshold for consensus (Lim et al., 2013). Table 4 presents the number of answers with the consensus degree of at least 61%.

Table 4: Degree of Consensus (Number of Questions)

Degree of consensus	Total	Academic	Government	Private
Total 61–74%	30	26	29	24
Total 75–100%	34	35	40	40
Total 61–100%	64	61	69	64
Total 61–100% (in %)	69.6	66.3	75.0	69.6

Similarly to the Croatian survey, only 64 statements (out of 92) had a degree of consensus above 61% also in Slovenia, since the NTA survey reached it in as many as 84 questions (out of 100). It is interesting that a slightly broader consensus was reached inside the government and the private sector in contrast to academia. If we were to take the degree consensus at 75%, the number of questions would drop significantly. The reasons for low consensus with the statements can be interpreted as a result of several issues. The survey was conducted in the time of crisis when the government made several corrections to the tax system in Slovenia, even during the tax year. This indicates an unstable tax environment. The same argumentation can also be found in Šimović et al. (2014) for the Croatian survey and Lim et al. (2013) for the USA survey in 1994. It is interesting that detailed analysis of all questions shows

[4] 1-strongly disagree, 2-disagree, 3-nor agree or disagree, 4-agree, 5 strongly agree

that the higher degree of consensus is reached on statements which are often debated in public (i.e. tax on immovable property, excise duties, VAT rates and personal income taxation). To some extent, higher consensus was reached when statements had a direct impact on a sector or individuals as such. There were only two statements with no grouped consensus, because of the opposite consensus in a different sector (taxation of other property, which was supported only by the government; and the opinion on interest tax shield). There were statements with high consensus in a sector, but that, at the same time, did not reach consensus in other sectors. Lower degree of consensus in the academic sector is more obvious since academics who analyse tax systems *per se* are rare in Slovenia, and we also included those who teach business finance or business law and management.

3.3 General opinions on different taxation

As mentioned above, the 92 statements are divided into several groups concerning special tax issues. The first group of 13 statements concerns property taxation and eight of them reached the percentage for consensus (61%). During the survey, a very strong debate on real estate tax in Slovenia was going on. The government announced new taxation, and public opinion was very much against its introduction. Two interest groups even initiated a procedure at the Constitutional Court and were successful, since the court decided that the law proposal was not in accordance with some principles of law. Therefore, it is interesting to note that the statement on the introduction of real estate tax reached an agreement in all three sectors (71%).

At the same time, the majority of answers to further statements indicate that some aspects of the current situation are supported (i.e. general allowance on determined size should also be included in the new tax; tax revenues thereof should remain at the local level). The highest disagreement was reached on the statement that individuals should pay higher tax than businesses (94%), but only 60% agreed on the statement that businesses should pay higher tax.

The respondents also support current sales tax of real estate (84%) and property being a necessary additional indicator of the ability to pay (76%). It is interesting that the statements that did not reach consensus are connected with other property taxation, including inheritance and gift tax. Similarly to the USA experts, Slovenian experts support equal tax burden for citizens and businesses, which contrasts with the opinion expressed in Croatia.

Personal income taxation was the topic of the next 14 statements. The evaluation of these statements was the most confusing. The experts agree on progressivity, since 76% disagreed on introduction of a single tax rate, while at the same time they disagree with lowering the number of tax brackets.

Experts are in favour of schedular taxation. There is high disagreement with lower taxation of dividends and capital gains in the government sector (above 80%), since the opposite opinion is predominant in the private sector (however, with lower consensus at around 60%), and equal distribution of agree/disagree opinions among academics.

A frequent debate in Slovenia is related to allowances. The Slovenian government introduced pre-filled tax returns in 2006; since then, all allowances connected to consumption of individuals have been abolished and the general allowance increased

instead. The majority of the experts in all three sectors support pre-filled tax returns, with a 100% among academics and the lowest percentage (88%) in the private sector. Nevertheless, at the same time, statements on the re-introduction of selected allowances (buying apartments or paying medical expenses) reached positive consensus. However, the academics are less in favour of re-introduction than the other two groups.

Statements considering business taxation are included in statements 30–41. The conclusion is that experts do not support further decrease of the tax rate, with the strongest disagreement among academics, and almost equal distribution in the private and government sector.

However, there are differences in experts' opinions about tax burden for SMEs (small and medium-sized enterprises). The academic sector disagrees with lower tax burden on SMEs (67%), since the private sector strongly supports it (84%).

The government and the private sector strongly support reinvesting profits to be exempt from taxation, while academics did not reach consensus and are even more against it. The highest consensus is reached for research, development and investment allowances, since all experts find them very important. It is interesting that strong support appears for the introduction of allowances for education and training of employees, but only from the private sector (86%) and the government (82%), while academics barely reached consensus (64%). None of the groups of experts support special regimes, like regional allowances and free zones.

The following 11 statements evaluate VAT. Experts are mostly against aiming at having only one (standard) VAT rate, and even more are against further increase of the VAT rate (94%, and even 100% for academics). This is probably because it is now in line with increased rates in other European countries, and still lower than in two neighbouring countries (Croatia and Hungary). Consensus is also reached on maintenance of reduced rates for basic foodstuffs as well as their extension to all food products. Statements 53 to 66 include different issues of excise duties. There is a high degree of consensus for most statements in the field of excise taxes. Most think that different excise taxes on energy and electricity should not be raised. In contrast, most think that excise taxes on tobacco products and alcohol should be increased, and that a special excise tax on unhealthy food should be introduced, but not for coffee. There was no consensus reached for sweet drinks, but more respondents were in favour of introduction. Experts also support tax on aircrafts and vessels, but not on cars.

Slovenian experts do not consider that the minimum monthly assessment base for social contributions should be abolished, and at the same time, they are in favour of a maximum base (a ceiling), especially the private sector (92%), and with no consensus among academics. Consensus is also reached for lowering health insurance rates, but again, only from the government and the private sector.

3.4 Experts' values and economic models

The last survey statements relate to general attitudes with regard to the tax system and policy as well as some economic models. These questions are mostly comparable to the Croatian and US surveys. In contrast to both surveys, no overall consensus has been reached for four of the statements, although consensus was not reached among

the private sector for only one statement. The lowest rate of consensus was reached among academics, which is due to different fields of expertise.

Most of the respondents are in favour of equity, when evaluating the traditional 'equity-efficiency trade-off' (85%). This attitude is expected, taking into consideration the previous survey parts about particular taxes. It could be explained by historical inheritance and the general solidarity awareness that prevails in Slovenia. To some extent, such an attitude could be as a result of recent different changes of the tax system arising from the economic crisis.

It is interesting that low consensus (68%) was reached for the statement that penalties for tax evasion should be increased, particularly with no consensus among the private sector. At the same time, very high consensus (92%, and even 100% among the private sector) among all three groups was reached on the statement that administrative and compliance costs are an important part of the tax policy.

High consensus was reached on tax structure, since all three groups agree that it should be changed; at the same time they all support a decrease of parafiscal levies. Regardless of this fact, there is no consensus on how the structure should change. The private sector supports a decrease in tax revenues and total government revenues/expenditures in GDP, while the other two groups did not reach consensus. The private sector also thinks that the burden should be shifted from profits to consumption, while there is strong disagreement among academics that any shift of the burden from profits to property should be undertaken, with opposite opinion from the government, and no consensus on that statement reached in the private sector.

Almost all three groups reached consensus in all statements concerning the tax changes in favour of supporting economic growth. Most think that lower marginal income tax rates increase work effort and reduce leisure (63%), and that such a change would increase the tax base so that the revenue lost could be compensated for (71%). Also, the majority think that non-taxation of interest encourages saving (75%), and respectively, that non-taxation of financial capital gains encourages investment and promotes economic growth (68%).

The bulk of these results are close to those in the US and Croatian surveys. Slovenian experts disagree (with consensus reached in all three groups) that VAT is unfair, because it is regressive and with less social correction. Similar to the opinion in Croatia, the statement on the efficiency of regional tax investment incentives did not reach general consensus. Only the private sector agrees on efficiency with consensus.

4. VALUES AND ECONOMIC MODEL ASSUMPTIONS

In order to determine attitudes related to value judgments and economic views related to behavioural responsiveness, we used serial binomial probit regression. We included only positive and negative answers (without neutral ones). For value judgments in the field of taxation, we used two questions as predictors (independent variables): Q77—The entire level of public revenues (and public expenditures) relative to GDP should be lowered, and Q91—The equity principle should have precedence over the efficiency principle in creating tax policy. To evaluate economic views of the respondents, we chose Q82—Lower marginal income tax rates reduce leisure and increase work effort, and Q86—Different government tax reductions

(reliefs, incentives) promote economic growth. In both cases, the regression also includes demographic characteristics (employment sector, age and education level) as independent variables. Since the number of respondents among academics is very low, we joined answers from academics and the public sector. We also joined answers from those with Master's Degrees or higher levels of education. The demographic characteristics were not analysed in particular. Nineteen different models were observed, wherein nineteen questions/statements that best reflect regular debates about Slovenian tax systems, and could be used to assess future tax trends, were chosen as dependent variables.

4.1 Influence of respondents' values

We tried to analyse the influence of tax equity values and general values concerning the government's role in the economy on professional attitudes about the tax system and policy. As mentioned above, we used two questions as predictors (Q77 and Q91 as independent variables), which express different views of respondents concerning tax policy. The respondents who support the reduction of the entire level of public revenues (and public expenditures) expressed as the level relative to GDP, could be regarded as those advocating a smaller role for the government in the economy. On the other hand, those that claim that equity is more important than the efficiency principle (compared to those who answered negatively) support a greater role in terms of equity (i.e. higher state intervention regarding redistributive issues). Therefore, the first group could be expected to be more in favour of consumption-based taxation, and lower taxation in general. Table 5 presents the results of binomial probit regression for variables Q77 and Q91 reflecting values in the field of taxation.

Table 5: Values and policy statements

		Q91 The equity principle should have precedence over the efficiency principle in creating tax policy	**Q77 The entire level of public revenues (and public expenditures) relative to GDP should be lowered**	χ^2
Q01	Slovenia should introduce the real estate tax.	-0.223 (0.43)	-0.13 (0.38)	4.112 [0.533]
Q03	Taxation should include other forms of property too (movable property, financial property, etc.), i.e. should be a synthetic taxation of property (net wealth tax).	0.521 (0.469)	0.226 (0.376)	3.929 [0.56]
Q06	Compensation tax on using building land should remain local tax after introduction of real estate tax.	0.593 (0.489)	0.307 (0.359)	4.478 [0.483]
Q14	Property is a necessary additional indicator of the ability to pay besides income.	0.351 (0.488)	0.513 (0.362)	13.777 [0.017]
Q16	Instead of more PIT rates, only one rate should be introduced (a flat tax) along with maintaining personal exemption.	-0.125 (0.459)	-0.334 (0.374)	3.765 [0.584]
Q23	Tax allowances for donations should be re-introduced instead of the possibility to re-direct personal income tax revenues.	0.841* (0.463)	-0.457 (0.373)	7.656 [0.176]

Q25	All sources of income inside PIT should be taxed in the same way (at statutory rates or at flat rate).	0.524 (0.597)	0.247 (0.373)	13.407 [0.02]
Q26	Capital incomes should be taxed at lower rates than other incomes.	-0.302 (0.484)	-0.899** (0.43)	12.198 [0.032]
Q27	Dividends should be taxed at lower rates than other incomes.	-0.14 (0.486)	-0.844** (0.412)	14.259 [0.014]
Q30	CIT (general) rate should be reduced.	0.27 (0.483)	-0.865** (0.413)	4.757 [0.446]
Q31	CIT burden for SMEs should be reduced.	0.001 (0.499)	-0.595 (0.411)	5.876 [0.318]
Q32	Re-invested profits should be exempt from taxation.	0.885* (0.467)	-0.468 (0.358)	6.444 [0.265]
Q39	Tax incentives for investment should be maintained.	0.185 (0.614)	0.268 (0.494)	5.209 [0.391]
Q53	A special tax on 'junk food' should be introduced.	-0.26 (0.471)	0.301 (0.374)	2.412 [0.79]
Q67	The ceiling for pension insurance contributions should be introduced.	-0.086 (0.516)	0.269 (0.466)	8.619 [0.125]
Q73	A financial transaction tax is justified special tax.	-0.967 (0.627)	0.474 (0.4)	11.057 [0.05]
Q74	Tax on banks balance sheet assets is justified special tax.	0.65 (0.533)	-0.422 (0.509)	8.564 [0.128]
Q76	General government should be financed less from taxes and more from different non-tax revenues (with an emphasis on different user charges).	0.839* (0.476)	1.275** (0.567)	12.379 [0.03]
Q92	Penalties for tax evasion should be increased.	-0.755 (0.704)	-0.22 (0.407)	9.041 [0.107]

Notes: Robust standard errors are in parenthesis. The p-values of the $\chi 2$ are in brackets. Other regressors include indicators of sector of employment, age and education.

Wald $\chi 2$ tests the hypothesis that at least one of the regression coefficients is not equal to zero.

** $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.*

Source: Authors' calculation.

Results of the analysis imply relatively inconsistent attitudes among Slovenian tax experts although for the majority of observed models, both groups of experts have almost similar preferences. The differences are visible in bank taxation, financial taxation and corporate income taxation. Furthermore, Q77 is a more significant predictor than Q91, which could imply that the general government burden is the dominant value in shaping tax attitudes for most of the experts. We expected that more liberal tax experts, i.e. those who answered Q77 positively, compared to those who are 'less' liberal (who answered Q77 negatively), would prefer to decrease most of the taxation and would devote less attention to the equity principle. The results showed that this was not fulfilled in several cases. The results of models showed that experts who answered Q77 positively are not inclined to reduce personal income tax rates for capital gains and dividends and the CIT rate. They also prefer collection of public revenues from non-tax resources rather than taxes.

Tax experts expressing a preference for a greater role of equity (those who reacted positively to Q91), compared to those who are less in favour of equity (negative answer to Q91), are more consistent and are, expectedly, more inclined to the re-introduction of a tax allowance for humanity purposes and to tax exemptions for reinvesting profits. It is interesting to note that they also prefer the collection of public revenues from non-tax resources rather than taxes.

If we compare these conclusions to those made in Croatia (Šimović et al., 2014) and the USA (Lim et al., 2013), we can observe that the Croatian results showed greater consistency among tax experts. Research in the USA showed similar inconsistency and also some unexpected preferences of levellers.

4.2 Influence of respondents' economic views

Q82—Lower marginal income tax rates reduce leisure and increase work effort, and Q86—Different government tax reductions (reliefs, incentives) promote economic growth, were used for taxpayers' behavioural response statements. According to the results, Q86 is a better predictor. The experts who answered positively to Q86 (compared to those who answered negatively) are more inclined to exempt the reinvested profits from taxation, to maintain investment allowance and to reduce CIT for SMEs. They are also inclined towards flat rate taxation of personal income and find property a necessary additional indicator of ability to pay. They preferred the re-introduction of allowances for humanity purposes and agree that the government should collect more revenues from non-tax sources. This approach is in favour of tax incentives and reliefs could be regarded as 'classical interventionist' approach, where economic efficiency is not understood in a sense of neutrality. Table 6 presents the results of a binomial probit regression for the stated variables.

Since it is narrower, Q82 turned out to be a less important predictor. The experts who answered this question positively are inclined only to increased penalties for tax evasion. It is obvious that those who prefer lower taxation of work incomes are against tax frauds and evasion.

Table 6: Economic views and policy statements

		Q82 Lower marginal income tax rates reduce leisure and increase work effort	**Q86 Different government tax reductions (reliefs, incentives) promote economic growth**	χ^2
Q01	Slovenia should introduce the real estate tax.	-0.562 (0.346)	-0.86 (0.552)	7.483 [0.187]
Q03	Taxation should include other forms of property, too (movable property, financial property, etc.), i.e. should be a synthetic taxation of property (net wealth tax).	-0.083 (0.329)	-0.529 (0.438)	5.149 [0.398]
Q06	Compensation tax on using building land should remain local tax after introduction of real estate tax.	0.128 (0.354)	0.907 (0.559)	11.047 [0.05]
Q14	Property is a necessary additional indicator of the ability to pay besides	0.104 (0.356)	0.735* (0.413)	21.885 [0.001]

	income.			
Q16	Instead of more PIT rates, only one rate should be introduced (a flat tax) along with maintaining personal exemption.	0.219 (0.368)	0.968* (0.497)	13.902 [0.016]
Q23	Tax allowances for donations should be re-introduced instead of the possibility to re-direct personal income tax revenues.	0.247 (0.334)	0.802* (0.436)	9.203 [0.101]
Q25	All sources of income inside PIT should be taxed in the same way (at statutory rates or at flat rate).	0.411 (0.328)	0.549 (0.427)	7.189 [0.207]
Q26	Capital incomes should be taxed at lower rates than other incomes.	0.352 (0.346)	0.424 (0.464)	12.66 [0.027]
Q27	Dividends should be taxed at lower rates than other incomes.	0.182 (0.343)	0.65 (0.513)	8.442 [0.133]
Q30	CIT (general) rate should be reduced.	0.411 (0.357)	0.687 (0.585)	7.79 [0.168]
Q31	CIT burden for SMEs should be reduced.	-0.584 (0.465)	1.762*** (0.633)	25.32 [0]
Q32	Reinvested profits should be exempt from taxation.	0.197 (0.372)	0.996** (0.451)	6.083 [0.298]
Q39	Tax incentives for investment should be maintained.	0.704 (0.441)	0.945* (0.56)	6.813 [0.235]
Q53	A special tax on 'junk food' should be introduced.	0.37 (0.336)	0.327 (0.422)	7.553 [0.183]
Q67	The ceiling for pension insurance contributions should be introduced.	0.53 (0.392)	0.563 (0.492)	14.677 [0.012]
Q73	A financial transaction tax is justified special tax.	0.073 (0.377)	-0.255 (0.523)	1.887 [0.865]
Q74	Tax on banks balance sheet assets is justified special tax.	0.038 (0.415)	-0.797 (0.594)	3.523 [0.62]
Q76	General government should be financed less from taxes and more from different non-tax revenues (with an emphasis on different user charges).	0.618 (0.428)	1.383** (0.574)	8.482 [0.132]
Q92	Penalties for tax evasion should be increased.	0.79** (0.368)	0.02 (0.411)	12.718 [0.026]

Notes: Robust standard errors are in parenthesis. The p-values of the χ2 are in brackets. Other regressors include indicators of sector of employment, age and education.

Wald χ2 tests the hypothesis that at least one of the regression coefficients is not equal to zero.

** p < 0.1; ** p < 0.05; *** p < 0.01.*

Source: Authors' calculation.

Researchers in Croatia and the USA used more predictors for economic views for evaluation of behavioural responsiveness. In the Slovenian research, we did not test economic incidence since statements that could be used as predictors did not reach consensus.

5. CONCLUSION

Research results imply that there is no high and broad consensus on tax policy among Slovenian tax experts, which is also evident in Slovenian practice. In most cases, tax changes in Slovenia have been made soon after political changes in the country, which is quite often in the past four years. It is also important to note that consensus was in most cases low, or not reached at two groups of questions: those that are frequently debated in public (i.e. increase of VAT), or those that are never an issue in public debates (tax incidence). Surprisingly, most of the experts think that different tax incentives influence economic growth, but at the same time, in most cases, they do not agree with lower taxation on labour and profits or other statements that are in line with theory. Instead, they put greater emphasis on tax allowances. Tax experts also did not reach consensus for statements connected with special regimes (i.e. free zones, regional allowances). In most cases, they do not support general theoretical assumptions about economic growth and are more in favour of budget consolidation. There was no consensus on lowering tax revenues in GDP and the consensus on lowering public revenue in GDP was barely reached. Yet, at the same time there was relatively high consensus on the statement that there should be a greater share of non-tax revenues (87%) in the budget. Such inconsistency in tax experts' opinion give government the opportunity to decide on its own priorities without consideration of the impacts of change beside those which directly influence the budget. Tax experts therefore probably do not have active role in preparing tax reforms.

A relatively low level of consensus is probably also the reason for greater inconsistency and lesser importance of predictors, especially concerning values and economic views of experts. Unfortunately, this also leads to inconsistent decision-making in practice. Several tax changes are therefore incompatible, short-term, and confusing.

It is acknowledged that the present study has limitations. We would probably get better model results and implications if we used only 'yes' or 'no' answers or at least only four-level evaluations. We would avoid neutral answers and consensus should be more easily reached. However, neutrality of tax experts is also an interesting signal for empirical purposes. Since the research is the first of its kind in Slovenia, the findings certainly contribute to the literature in the field.

For future research, two directions can be proposed. Firstly, similar investigations can be done among citizens as completed in the USA (Lim et al., 2013). Such research can enlighten tax experts' opinion in different ways. Secondly, the same research can be done after a few years, to determine the development in tax experts' opinion and make comparisons over time.

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Specific rewards for tax compliance: Responses of small business owners in Ekurhuleni, South Africa

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Abstract

The literature reviewed documents the positive effects of rewards in encouraging desired behaviour, but rewards may have a crowding-in effect, strengthening intrinsic motivation, or a crowding-out effect, weakening it. External interventions may therefore be perceived as supportive, fostering self-esteem and self-determination, while those perceived as controlling may have the opposite effect. A number of countries have adopted a strategy of rewarding tax compliance. The rewards range from certificates awarded to compliant taxpayers, to privilege cards providing opportunities for discounts or special treatment, to lotteries in which compliant taxpayers can participate. The reward strategies are often accompanied by publicity programmes. Two such hypothetical strategies were presented to participants in a survey conducted amongst small business owners in Ekurhuleni, South Africa, to gauge their responses. The first strategy, presented in the form of a vignette, involved a lottery scheme and the second, a tax compliance certificate and public recognition. The results of the research indicate support by the participants for the acknowledgement of tax compliant behaviour by the tax authorities, with very little difference between the responses to the two types of strategy. It also appeared that there was little difference between the responses, based on the type of industry, the gender, race or level of education, but the variables of age and the size of the business indicated a more favourable perception by younger entrepreneurs and smaller businesses.

Key words: *Tax compliance; rewards; intrinsic motivation; crowding-in and crowding-out theory; controlling interventions.*

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1. INTRODUCTION

Braithwaite (2002) states that the one point on which psychologists and economists agree with in respect to motivating human behaviour, is that rewards are more useful than punishments. Feld, Frey and Torgler (2006) remark that a persistent theme in the tax compliance literature in the last few years is to move away from deterring non-compliance towards positive encouragement for compliance. They consider it highly relevant to investigate possible effects of rewards on tax compliance behaviour and thus move beyond standard theories of tax evasion. The Commonwealth Association of Tax Administrators (2006) reports on a number of positive incentives and strategies used by countries to encourage greater compliance. These include taxpayer assistance and education; providing information, tools and guidance to help taxpayers to comply; providing taxpayers with the opportunity to voluntarily disclose; involving taxpayers in consultative forums; and providing incentives or rewards for compliance.

Andreoni, Erard and Feinstein (1998) believe that finding ways to reduce tax non-compliance is of obvious importance to nations around the world. The present study presents a glimpse into why positive encouragement (as opposed to deterrence) could potentially be considered as a strategy to achieve higher levels of compliance. To this extent, the study also draws on principles for rewarding pro-social behaviour as is prevalent in the marketing environment.

Strategies of providing rewards for tax compliance are, for example, found in Sri Lanka, the Republic of South Korea, and Kenya (The Commonwealth Association of Tax Administrators, 2006: 58). An example of such a reward is privilege cards offered to consistently compliant taxpayers by the Inland Revenue Department (IRD) of Sri Lanka. These cards provide benefits such as special treatment from key government bodies like Customs and the Police Service, preferential treatment at the airport, as well as several other concessions, including leasing facilities for the purchase of vehicles and office equipment at reduced interest rates from the Peoples Bank and the Bank of Ceylon (IRD, 2012). These cards are, however, only issued to high net worth taxpayers. Other benefits such as discounts on income tax for early payment and a reduction of import tax on motor vehicles are also offered to compliant taxpayers (Gajendran, 2013). For additional examples of reward schemes currently in use by various countries to encourage tax compliance, see Bornman (2014) and Fatas, Nosenzo, Sefton and Zizzo (2015).

In South Africa at present, no reward strategy exists that offers tangible benefits to compliant taxpayers. Although the South African Revenue Service (SARS) states that 'the vast majority of our citizens are law-abiding and share a sense of responsibility to actively participate in building our country through making their fair tax contribution' (SARS, 2012: 4), it is questionable whether SARS is doing enough to give recognition to these voluntarily compliant taxpayers.

The aim of this article is to present and analyse the opinions of small business owners from Ekurhuleni, South Africa, on two specific reward strategies that are similar to strategies being used in Kenya and Mauritius. The article will first provide an overview of the concept of rewarding tax compliant behaviour, and then extracts principles for rewarding pro-social behaviour from literature in the marketing environment. Reward strategies used in Kenya and Mauritius will be described before the results of the survey with the small business owners are presented and discussed. The reason for selecting these two strategies is that one reward offered is of a

relational nature without a specific monetary value (Kenya), whereas the other type of reward consists of a monetary incentive (Mauritius).

2. LITERATURE REVIEW

2.1 The concept of rewarding tax compliance

Alm, Jackson and McKee (1992) first tested the effect of positive rewards on tax compliance behaviour experimentally and found that positive incentives are effective in encouraging honest reporting. Similar results were reported by Torgler (2003) and Bazart and Pickhard (2009). A number of authors in tax compliance literature have suggested strategies for rewarding tax compliance. For example, Feld, Frey and Torgler (2006) suggest a certificate of compliance and argue that it may increase a firm's reputation and image and have a positive impact on shareholders and customers. The Cash Economy Task Force (2003) suggested a similar reward and added that the effectiveness of this approach could be enhanced by a communication programme which encourages the community to support complying businesses. Frey and Neckermann (2006) reason that rewards operate through the innate desire of human beings for recognition and status; they suggest rewards in the form of medals and prizes.

In an experimental study by Kastlunger, Muehlbacher, Kirchler and Mittone (2011) on the effect of rewards on tax compliance (with 86 students) it is reported that completely honest tax reports were more often observed in the reward conditions and that, apparently, rewards have also increased the tax payments of 'mild-evaders'.

More recently, Fatas et al. (2015) conducted an experiment comparing two audit-based deterrence mechanisms that collect fines from those found to be non-compliant. The fines are then redistributed to individuals who were either not audited or audited and found to be compliant. The first distribution mechanism does not discriminate between the un-audited and those found compliant, whereas the second targets the redistribution in favour of those found to be compliant. Their findings indicate that targeting increases compliance when paying taxes generates a social return. Their explanation supports the notion that rewarding compliance may increase the rate of compliance.

Fatas et al. (2015) also administered a treatment where those found compliant were given 'symbolic' rewards, i.e. rewards of negligible material value. Their findings from the treatment displayed no increase in compliance relative to the untargeted treatment, and they concluded 'that it is not the mere assigning of rewards, but the material incentives inherent in the rewards that improve compliance' (Fatas et al., 2015: 14). It is submitted that this finding agrees with Bornman's (2014) suggestion that an incentive to encourage tax compliance can be perceived as a reward if it is regarded as valuable by the recipient.

In another study, the positive effect of rewards on tax compliance behaviour is challenged. Fochmann and Kroll (2014) suggest that up to now, no paper analyses the effect of positive and negative perceptions regarding the use of tax revenues. Using a laboratory experiment they apply different reward mechanisms to redistribute collected tax revenue. These are: 1) an Equal-Distribution treatment where the collected tax revenue is redistributed equally among all subjects; 2) a Pro-Social-

Behaviour reward treatment, where the collected tax revenue is redistributed to the subjects with the highest contribution to the public good within a group; and 3) an Anti-Social-Behaviour reward treatment, where the tax revenue is redistributed to the subjects with the lowest public good contribution.

Based on their results, Fochmann and Kroll (2014: 25) conclude that 'rewards have either no effect (for those who are rewarded) or a negative effect (for those who are not rewarded) on tax compliance behaviour'. They suggest a possible explanation in that rewards can have opposing effects on the willingness to comply with the tax law. Low trust in the tax authority on the one hand (for those likely to receive no reward) and unequal treatment of taxpayers on the other hand (as experienced in the Equal-Distribution treatment) can lead to a lower tax compliance rate in relation to the treatment of rewards.

2.1.1 Definition of a reward for tax compliance

Bornman (2014) defined a reward for tax compliance as an incentive administered by a tax authority with the objective of encouraging voluntary compliance. The aim of such a reward is to show appreciation and recognition for voluntarily achieving a desired outcome and as recognition of the competence of taxpayers. The reward can be of a tangible or relational nature, but should be perceived as valuable by the recipient.

2.1.2 Rewards and motivation crowding theory

Frey and Jegen (2001) describe motivation crowding theory as the effect of undermining or strengthening intrinsic motivation by external intervention via monetary incentives or punishments. This theory originated from the work of Titmuss and from literature on cognitive social psychology. In his book *The Gift Relationship* published in 1970, Titmuss argued that paying for blood undermines cherished social values and would therefore reduce the willingness to donate blood. Feld et al. (2006) explain that motivation crowding theory suggests that outside interventions such as deterrence, that are perceived to be controlling, tend to crowd-out intrinsic motivation, whereas actions perceived to be supporting tend to crowd-in intrinsic motivation. The study by Frey et al. (2001) can be regarded as authoratative in that it demonstrates that the crowding-out and crowding-in effects are empirically well founded and have been observed in many different areas of the economy and society.

Frey et al. (2001) distinguish three effects of external intervention on performance:

1. if the external intervention increases intrinsic motivation, crowding-in of intrinsic motivation occurs and the performance is enhanced;

2. when external intervention undermines intrinsic motivation (crowding-out), performance will deteriorate as the recipient's marginal benefit from performing is negatively affected; and

3. in general, both of the above effects are active, so external intervention has two opposite effects on the agent's performance; to make a decision on whether intervening is appropriate and beneficial for the principal, depends on the relative size of the two countervailing effects.

According to Frey et al. (2001: 594) the effect of external interventions on intrinsic motivation is attributed to two psychological processes, namely:

1. Impaired self-determination. When an external intervention is perceived as reducing self-determination, the locus of control shifts from inside to outside of the person affected. According to Rotter ((1966), as cited by Frey et al. (2001)), individuals who maintain their intrinsic motivation when forced to behave in a specific way by outside intervention, feel overjustified. The individual's own interest in performing the activity is discounted because he or she is given an external reason for doing something they would have done anyway.

2. Impaired self-esteem. Outside intervention that conveys the message that the individual's motivation is not acknowledged, effectively rejects the intrinsic motivation of the individual. When this happens, the individual feels that his or her involvement and competence is not appreciated and as a result its value degrades and leads to a reduced effort by the individual.

Frey et al. (2001) thus describe the following psychological conditions under which the crowding effect appears in a manner similar to the findings of Deci, Koestner and Ryan's analysis of the effects of rewards on intrinsic motivation (1999):

1. external interventions that are perceived as controlling by the individual will crowd out intrinsic motivation because self-determination and self-esteem is negatively affected; and

2. external interventions that are perceived as supportive will crowd in intrinsic motivation because self-esteem and self-determination are fostered.

Frey et al. (2001) found consistently strong empirical evidence for crowding-out and crowding-in from a substantial number of experimental studies done by several scholars. These studies were done on different intrinsically motivated behaviour such as volunteer work, civic duty, work effort and blood donation.

From the discussion of motivation crowding theory, it can therefore be concluded that rewards for tax compliant behaviour should be supportive (and not controlling) and should acknowledge the individual's motivation for performing the action. Costa-Font, Jofre-Bonet and Yen (2013) hypothesised that a non-controlling or supportive reward will typically be a non-monetary award. By analysing a large dataset representative of fifteen European countries containing information both on whether or not an individual had been a donor in the past and his or her preferences for monetary and non-monetary compensation for blood donation, they found that monetary incentives will crowd out intrinsically motivated behaviour, but non-monetary incentives will not. Also, a reward that is perceived as an expression of appreciation is likely to be perceived as non-controlling (Bornman, 2014). Braithwaite (2002) states that informal praise as a reward seems to have unequivocally positive effects on compliance. He reasons that praise is a gift — it is not required — therefore people will normally not interpret it as an attempt to be manipulated. He further states that the power of a reward resides in the affirmation of identities, in this case, law abiding identities.

2.2 Principles for rewarding socially desired behaviour derived from the marketing environment

Privilege cards for compliant taxpayers are reminiscent of loyalty programmes often found in the retail environment. One can argue that a tax authority does not have loyal customers, but it is evident from an Organisation for Economic Co-operation and Development information note on managing and improving tax compliance (OECD, 2009) that many tax authorities refer to taxpayers as 'customers', and regard 'customer service' as a priority. A Warc Exclusive report (2010) states that it costs more to attract new customers than to retain existing ones and that a company's relationship with an existing customer can be more effectively built, and more efficiently managed, than the more distant contact that might exist with lapsed or non-customers. It is submitted that the analogy in terms of the tax authority and taxpayers is that voluntarily compliant taxpayers can be regarded as existing customers with whom the tax authority has a relationship that needs to be managed.

Kotler and Zaltman (1971) reason that the core idea of marketing lies in the exchange process between two or more parties. To iniate social change (e.g. safe driving, family planning, tax compliance), social marketing is used as a tool in the exchange relationship between client and the change agent.

2.2.1 Social marketing

Social marketing is a term used in the marketing environment to refer to the marketing efforts by non-profit organisations and governments and usually involves seeking to influence social behaviours to benefit the target audience and society in general (Weinreich, 2006). Social marketing efforts will always convey a message: be it that change can save money or lives or can make the world a better place; or to appreciate and recognise desired behaviour (Bornman, 2014). Thus, the message becomes the reward. For example, in order to reduce a high volume of short car journeys (to reduce carbon dioxide emissions in a specific area), a local authority distributed a series of mock coupons offering '£3 off your next shop', explaining that this is the average cost of a return car journey to the shops or supermarkets in the local area (including parking charges) (Dolan, Hallsworth, Halpern, King, & Vlaev, 2010). Therefore, although no physical reward was received, a message to encourage change can result in people saving money and making the world a better place (reducing carbon emissions), which in itself then becomes the reward. In a tax compliance context, a pertinent example is a television advertisement by the South African Revenue Service (SARS) depicting how the life of a specific South African has changed because government was able to provide the infrastructure and services needed (in his case a local clinic and visiting doctor who removed cataracts from his eyes and enabled him to see again (SARS, 2013)). In the advertisement SARS thanks taxpayers for making a real difference to the lives of people throughout the country by paying their taxes and for building a better South Africa.

2.2.2 Loyalty programmes and reward cards

Loyalty schemes are very popular. A Warc Exclusive Report (2010) indicates that in 2009 there were 1.3 billion US loyalty scheme memberships, or four for each citizen in the United States. A study by Directivity and Citrus (2013) amongst 1005 Australian citizens concluded that loyalty programmes are all about the financial rewards and benefits they offer, and that satisfaction with the reward itself is important

(not so much a feeling of appreciation or gratification); they suggest that rewards should preferably have financial benefits. Dolan, Hallsworth, Halpern, King, and Vlaev (2010) state that 'people dislike losses more than they like gains of an equivalent amount'. They suggest as an alternative that incentives could be framed as a charge that will be imposed if people fail to do something. They cite a recent study on weight loss where participants were asked to deposit money into an account, which was returned to them (with a supplement) if they met weight loss targets. After seven months this group showed significant weight loss, whereas the weight of participants in a control group (who did not deposit the money) was not seen to change. The fear of losing money may have created a strong incentive to lose weight.

Bornman (2014) summarises the implications of loyalty schemes and other types of reward schemes for rewarding tax compliance as follows:

1. a reward is seen as being given something in return for your contribution to the public good (other than the public good itself);
2. a reward must have a perceived value for the customer (taxpayer);
3. the perceived value can also be the avoidance of a loss;
4. rewards must distinguish (recognise) and be given to those who meet the criteria;
5. rewards can be given as a token of appreciation; and
6. a reward does contribute to loyalty (compliance) although it will not necessarily create loyalty (compliance). Customers (taxpayers) are more motivated to comply with, than without the reward.

In the following section, two actual reward strategies used by tax authorities are reviewed, one which is more of a relational nature (social marketing) and one which offers a monetary incentive (lottery scheme).

2.3 Reward strategies used in Kenya and Mauritius

Some tax administrations are rewarding taxpayers for demonstrating good compliance behaviour. For example, the Kenya Revenue Authority (KRA) hosts an annual taxpayers' week during which the most distinguished taxpayers in the country are rewarded with certificates (The Commonwealth Association of Tax Administrators, 2006). The Mauritius Revenue Authority (MRA) introduced a lottery draw in 2012 which allowed all taxpayers who filed their returns electronically to automatically participate (MRA, 2012). The two strategies are described in more detail below.

2.3.1 Kenya

During the Taxpayers' Week activities such as tax clinics, tax education sessions, and community based initiatives take place, aimed at supporting the needy within society. A special taxpayers' luncheon is also held during which awards are given to compliant taxpayers in various categories: per tax type, top regional taxpayers, and a special category of taxpayers. Awards consist of trophies and certificates and in addition, a list of names of taxpayers with a special commendation from the Commissioner General of Taxes is also released. The week is characterised by song and dance and

the speeches delivered at certain events are broadcast on national television (KRA, 2004).

Emphasis is placed on appreciation and recognition of compliant taxpayers and the role they play in the development of the country. The speech by the President of Kenya, the Hon. Uhuru Kenyatta, during the 2013 Taxpayers' Week stated: 'This occasion is important. It is the occasion when we recognise and celebrate our taxpayers for their contribution and productivity to our national development agenda, and, indeed, our civilization' (State House Kenya, 2013).

This type of strategy can be described as supportive (and not controlling) as it does not appear to be manipulative. It should not impair self-determination as the reward is not big enough to have the effect of shifting the locus of control from inside to outside the person affected. Because of the praise and recognition of taxpayers, it can also boost self-esteem by affirming the identity of taxpayers. It can thus be submitted that this reward strategy will crowd in intrinsic motivation because self-esteem and self-determination are fostered.

Although no official publication commenting on the success of this strategy in encouraging tax compliance could be found by the authors of the present article, it is assumed that the annual taxpayers' week is regarded as a worthwile effort by the Kenya Revenue Authority as it has been held annually since 2004.

2.3.2 Mauritius

The Mauritian scheme entails the following: all taxpayers who file their returns electronically (e-file) participate automatically in the lottery draw and 20 prizes worth Rs 210 000 are awarded (MRA, 2012). Although the objective of the scheme is to motivate taxpayers to file their returns electronically, the Mauritius Revenue Authority states that the lottery scheme is part of a nationwide campaign to establish a tax culture in Mauritius (MRA, 2014a). Based on the definition of a reward for tax compliance, it can therefore be classified as a strategy to reward tax compliance.

The extent to which this type of reward can be perceived as supportive, is arguable. Firstly, the announcement of the strategy included no communication relating to appreciation or recognition of taxpayers and, secondly, the strategy is prescriptive — only those who e-file can qualify for the reward — which may not be perceived as strengthening taxpayers' autonomy. According to motivation crowding theory, this type of reward can crowd out intrinsic motivation because self-determination and self-esteem is negatively affected, and the motivation to comply can change from intrinsic to extrinsic (to obtain the reward).

It appears that the campaign was successful, since the MRA also introduced a VAT lucky draw scheme, whereby taxpayers who submit the details of a tax invoice received via SMS or website to the MRA can win up to Rs 50 000. The objective with this scheme is to promote the good habit of asking for a receipt and to issue VAT invoices for all sales / transactions (MRA, 2014b).

In describing similar reward strategies to small business owners from Ekurhuleni and eliciting their responses, their perceptions on the use of such strategies to reward tax compliance are investigated in this study. The following section describes the methodology applied, then the results and conclusion are presented.

3. METHODOLOGY

The opinions of small business owners from Ekurhuleni, a metropolitan area in Gauteng, South Africa, were obtained by means of a semi-structured questionnaire developed by the researchers. No database exists of all small businesses in the area and a sample frame was compiled using online sources.

Ekurhuleni is a metropolitan area with a population of approximately 3 178 470 people; this represents about 6% of South Africa's population. The area includes nine towns and 13 townships (towns where, traditionally, mainly black South Africans live). According to the Ekurhuleni Metropolitan Municipality (EMM) the area contributes approximately 18% to the total economic output of the Gauteng province, is home to South Africa's biggest international airport and is considered to be an economically active area with a large diversity of industries (EMM, 2013). Because of the large concentration of small businesses in a relatively small area (1 975 square kilometres), the diversity in type of industries, race and income levels, and the location of Ekurhuleni in the province of Gauteng, the most economically active province in South Africa, the Ekurhuleni Metropolitan area was considered to be suitable for selecting respondents for the present study.

3.1 Survey instrument

Two scenarios of possible rewards by the South African Revenue Service were included in a survey instrument administered face to face to participants with the help of fieldworkers during November 2013. The scenarios were presented to respondents in the form of vignettes or short descriptions of hypothetical situations followed by a non-standardised questionnaire. Kirchler and Wahl (2010) reason that by using fictitious cases for assessing attitudes towards tax evasion, the problem of social desirability could be reduced and respondents will be less hesitant to reveal their true attitude toward paying taxes. Opinions of respondents on certain statements pertaining to these hypothetical strategies were measured on a five-point Likert scale, followed by open-ended questions in which respondents could provide reasons for their support or rejection of such a scheme of rewards. Leedy and Ormrod (2010: 189) confirm that rating scales such as the Lickert scale are useful when evaluating attitudes of respondents.

3.2 Population

Respondents were selected from small business owners in the real estate and construction industry. These industries were chosen based on previous research by The Commonwealth Association of Tax Administrators (2006) that indicated that these sectors are high on the list of likely non-compliant industries. In a South African context, SARS considers the construction industry to have one of the poorest compliance rates of all industries whilst being a major beneficiary of government spending in relation to planned infrastructure programmes (SARS, 2012: 34).

No accurate database exists from which to have selected a random sample of participants and therefore non-probability sampling was used. A quota was determined for each industry and business contact details were obtained from the South African Estate Agents Affairs Board website and the Electronic Yellow Pages (an online telephone directory). Six fieldworkers were each instructed to have 30 questionnaires completed by small business owners, using the business names and

contact details identified in the quota. The final sample was thus based on voluntary participation and a total of 180 questionnaires were completed, of which 176 could be used for the analysis.

3.3 Data analysis

The data were captured using SPSS and were summarised in the form of frequencies and percentages in a report format. The report was analysed using descriptive statistics and relevant statistical tests were used to compare the results for different groups within the sample.

4. RESULTS AND DISCUSSION

4.1 Demographic information

The demographic characteristics of the sample are displayed in Table 1 below.

Table 1: Demographic information (n = 176)

Variable		**Frequency (%)**
Gender	Male	58.5%
	Female	41.5%
Age	20-25	9.8%
	26-35	35.0%
	36-45	32.5%
	46-55	14.1%
	56 and older	8.6%
Ethnicity	Black	38.1
	White	44.9
	Coloured	7.9
	Indian or Asian	9.1
Educational level	Grade 12 and lower	44.2%
	Post Matric diploma or certificate	34.5%
	Degree or post-graduate	21.3%
Type of industry	Estate agent	35.4%
	Construction	57.3%
	Other	7.3%
Size of the business	Work alone	3.4%
	1-10 employees	65.7%
	More than 10 employees	30.9%

Only 55 per cent of the participants were the owners of the respective businesses. The remainder of the respondents were managers or bookkeepers (27%), and agents,

administrative clerks or sales persons (18%). Although it could be argued that the fact that not all the respondents were small business owners renders the results less valid, their participation in the survey was none the less valid as 94 per cent of the sample (or 166 respondents) indicated that they were aware of what the standing of the business with SARS was, with regard to income tax. Within this group of 166 respondents 82 per cent indicated that the tax function was their responsibility. This indicates that they could participate meaningfully in the survey.

A total of 141 respondents indicated that the business makes use of a tax practitioner to complete tax returns, that is, almost 80 per cent. Earlier research by Langham, Paulsen and Hartel (2012) indicated that taxpayers' reliance on tax practitioners may decrease their tax awareness and may actually reduce levels of voluntary compliance. The implications for the survey are that some business owners may have low levels of tax awareness as they leave the tax decision in the hands of a tax practitioner. This may result in an apathetic response to the questionnaire. On the other hand, the fact that so many of the businesses make use of a tax practitioner might be an indication of high levels of compliance by the majority of businesses included in the sample.

4.2 Results of the first scenario

Details of the first scenario presented to participants and their responses are provided below.

4.2.1 Vignette 1

SARS announces that for the 2014 year of assessment, they will implement a lottery scheme in which all tax registered small businesses can participate. A small business that submits its income tax return on time, will receive a lottery ticket and be entered into the draw to take place at the end of 2014. The winner will be subject to an audit to verify the correctness of information submitted before the prize is awarded and if found to be non-compliant, a second winner will be drawn subject to the same audit procedure. The prize will be of substantial monetary value and will be awarded at a public occasion that will be covered by all major media networks in South Africa.

Results per statement based on Vignette 1, indicating the mean, mode and standard deviation are displayed in Table 2. Respondents could select on a scale from 1 to 5, where the value 1 represented 'strongly disagree' and the value 5 represented 'strongly agree'.

Table 2: Responses on statements B1-B5 based on Vignette 1 (n = 172)

Statement	Mean	Mode	Standard deviation
B1. This scheme will have an effect on my current tax behaviour	3.09	4	1.283
B2. This scheme will motivate me to do my best to meet the submission date deadline for the business' income tax return	3.42	4	1.184
B3. It is an initiative that can have a positive effect on many small business owners' tax behaviour	3.69	4	0.982
B4. I object to the use of a lottery on religious or cultural beliefs	2.39	2	1.102
B5. I believe it will be an unfair system	2.57	3	1.130

Table 3 illustrates the spread of responses per statement.

Table 3: Detailed responses per statement for Vignette 1

Statement		Strongly disagree	Disagree	Neutral	Agree	Strongly Agree	Total
B1. This scheme will have an effect on my current tax behaviour	Count	24	36	39	47	26	172
	%	14.0%	20.9%	22.7%	27.3%	15.1%	100.0%
B2. This scheme will motivate me to do my best to meet the sub-mission date deadline for the business' income tax return	Count	14	25	40	61	32	172
	%	8.1%	14.5%	23.3%	35.5%	18.6%	100.0%
B3. It is an initiative that can have a positive effect on many small business owners' tax behaviour	Count	7	11	43	79	32	172
	%	4.1%	6.4%	25.0%	45.9%	18.6%	100.0%
B4. I object to the use of a lottery on religious or cultural beliefs	Count	35	69	47	6	14	171
	%	20.5%	40.3%	27.5%	3.5%	8.2%	100.0%
B5. I believe it will be an unfair system	Count	38	36	72	14	12	172
	%	22.1%	20.9%	41.9%	8.1%	7.0%	100.0%

It is notewothy that the responses to statement B3 are more in agreement with the statement than the responses for statements B1 and B2. This points to the fact that respondents believe it may change the tax behaviour of other small business owners, but not to the same extent on their own behaviour. It was stated earlier that levels of tax compliance may be high for the sample (due to the high awareness of the tax status of the business and the high incidence of the use of tax practitioners by the respondents). This could explain why being eligible for a reward may not have such a strong effect on their tax behaviour, since many of them are already tax compliant.

The majority of respondents did not object to the use of a lottery because of religious or cultural values and the majority also indicated that they did not believe it would be an unfair system. In a subsequent statement respondents had to state 'yes' or 'no' to indicate their support for such a scheme and 58 per cent of respondents answered 'yes'.

4.2.2 Reasons for support of the scheme

The main reasons provided by respondents for supporting the scheme were that it could be motivational or beneficial to small business owners. A total of 95 responses were received in which they gave reasons why they would be in support of the scheme. Of these 45 gave reasons relating to 'motivational' and 35 reasons relating to 'beneficial'. Reasons relating to 'motivational' expressed the belief that the scheme would encourage people to take tax issues seriously, while reasons relating to 'beneficial' indicated that the money to be won in a lottery could be beneficial to the growth of a small business. The remainder of the responses reflected a variety of themes, including: 'it is a good idea'; 'it will compensate me for my effort to pay taxes'; and 'it brings joy to know people appreciate what you are doing.'

The fact that many respondents believed that it could be beneficial to a small business confirms the principle stated earlier that a reward must have a perceived value for the customer.

4.2.3 Reasons for objecting to the scheme

A total of 64 responses were received giving reasons for not being in support of the scheme. No single main theme could be inferred from the responses. Reasons such as 'tax compliance is a civic duty that should not be rewarded'; 'there is only one winner'; 'it is unfair to people without their own businesses'; and 'SARS should not pay people back when there is so much to do for the community', were amongst the common responses.

4.2.4 Concerns expressed by respondents in respect of a scheme suggested by Vignette 1

Although 95 responses were received, only 74 responses were useful since 21 responses either did not express a concern or were incomprehensible. The most significant response was the concern that corruption would prevail when a lottery system is introduced to reward tax compliance. A few respondents also felt that a lottery system will send out the wrong message, namely that 'luck is better than hard work'.

4.3 Results of the second scenario

4.3.1 Vignette 2

SARS announces that all small businesses that submit tax returns on time in 2014 will be presented with a certificate that will be issued to every small business individually. The certificate is printed on expensive paper, with black and gold lettering and is framed so that it can be displayed in the office of the business. The certificate will state that the business was found to be tax compliant and is declared a member of the South African Tax Compliant Community. This community will then be a select group of small businesses with certain privileges, such as being publicly acknowledged as a tax compliant business, and business contact details will be publicly accessible to any interested party looking to deal with businesses that embrace a culture of compliance with the laws of the country. This database will be updated annually and business' names will be removed if in any given year they are found to be non-compliant with regard to income tax law in South Africa.

Results per statement based on Vignette 2 indicating the mean, mode and standard deviation are displayed in Table 4.

Table 4: Responses on statements B10-B14 based on Vignette 2 (n=171)

Statement	Mean	Mode	Standard deviation
B10. This scheme will have an effect on my current tax behaviour	2.89	4	1.339
B11. This scheme will motivate me to do my best to meet the submission date deadline for the company's income tax return	3.09	4	1.227
B12. It is an initiative that can have a positive effect on many small business owners' tax behaviour	3.3	4	1.185
B13. I will be proud to display such a certificate on a wall in my company for everybody to see	3.41	4	1.235
B14. I believe this scheme will help to build a culture of compliance with tax laws in SA	3.33	4	1.232

Table 5 illustrates the spread of responses per statement.

Table 5: Detailed responses per statement for Vignette 2

Statement		Strongly disagree	Disagree	Neutral	Agree	Strongly Agree	Total
B10. This scheme will have an effect on my current tax behaviour	Count	34	37	36	40	23	170
	%	20.0%	21.8%	21.2%	23.5%	13.5%	100.0%
B11. This scheme will motivate me to do my best to meet the submission date deadline for the company's income tax return	Count	26	32	34	57	21	170
	%	15.3%	18.8%	20.0%	33.5%	12.4%	100.0%
B12. It is an initiative that can have a positive effect on many small business owners' tax behaviour	Count	20	20	42	68	22	172
	%	11.7%	11.6%	24.4%	39.5%	12.8%	100.0%
B13. I will be proud to display such a certificate on a wall in my company for everybody to see	Count	20	17	39	63	32	171
	%	11.7%	9.9%	22.8%	36.9%	18.7%	100.0%
B14. I believe this scheme will help to build a culture of compliance with tax laws in SA	Count	19	25	35	64	28	171
	%	11.1%	14.6%	20.5%	37.4%	16.4%	100.0%

A similar phenomenon as with the responses to Vignette 1 is observed with respect to the belief of respondents that the scheme will have a greater impact on other small business owners' tax behaviour than on their own behaviour.

In general, more respondents are in agreement with the statements for Vignette 2 than those who disagree. The high frequency of responses that agree and strongly agree to statement B13 and B14 in particular, indicates that most respondents are in favour of being recognised for their tax compliant behaviour. The question eliciting overall support for the scheme resulted in 61.5 per cent of respondents responding with a 'yes', which is largely similar to the support expressed for Vignette 1 (58%).

4.3.2 Reasons for support of the scheme

A total of 90 responses giving reasons for their support for the scheme were analysed and three main themes emerged, namely: (1) the scheme will be a motivation to be tax compliant; (2) the scheme will have a positive impact on small businesses because it will attract customers or increase the trust of customers in the business; (3) people will enjoy the recognition they will receive for being tax compliant. These reasons made up 90 per cent of the responses, in an equal ratio.

4.3.3 Reasons for objecting to the scheme

Of the 58 responses analysed, 25 believed that the scheme would hold no benefit for a small business. Other frequent responses relate to the belief that the scheme is not motivational (7 responses) and that tax compliance should not be rewarded (5 responses). Some respondents indicated that they would prefer other types of reward (11 responses).

Again, the principle that a reward must be perceived as having value by recipients is strongly supported by the results.

4.3.4 Concerns of respondents with regard to a scheme suggested by Vignette 2

The two major concerns identified from a total of 68 responses analysed, are 'corruption' (23 responses), and 'lack of value in the reward' (25 responses). Other responses include a concern for the high cost (10 responses) and a concern that the scheme would be an administrative challenge (5 responses). The fear of corruption relates to a belief that non-compliant small business owners will forge the certificate or that false certificates will be available for purchase.

4.3.5 Comparison of results for Vignette 1 and 2

The mean values for the statements determining respondents' perceptions about Vignette 2 are somewhat lower than those for Vignette 1, indicating that respondents may believe that Vignette 1 has a higher motivational value. This corresponds with the finding by Fatas et al. (2015) that 'symbolic rewards are not sufficient, it is the material incentives inherent in the rewards that improve compliance'. In the present research, for example, the statement 'It is an initiative that can have a positive effect on many small business owners' tax behaviour' for both vignettes, reflects a higher mean value for Vignette 1 (3.69) than for Vignette 2 (3.3); and a lower standard deviation (0.982 versus 1.185), although the overall support for Vignette 2 was slightly higher at 61.5 per cent (Vignette 1 had a 58 per cent level of support).

The standard deviations on each statement relating to respondents' perceptions about the vignettes are higher for Vignette 2 than for Vignette 1, pointing to a larger spread of the data for Vignette 2 (and accordingly opinions that are not as strong). It was also found that the responses to the open-ended questions were more subdued for Vignette 2 than for Vignette 1.

4.4 Comparison of results between different groups

Using independent-samples t-tests and one-way analysis of variance tests where appropriate, the mean scores for the following groups were compared: gender; type of industry; size of business; owner status; tax awareness and responsibility; whether or not respondents are using a tax practitioner; age; race; and level of education. For the purpose of the comparison, the scales for each vignette were reduced to a single factor per vignette; an exploratory factor analysis confirmed that the items on each vignette scale could be reduced to one factor.

A significant difference between mean scores for specific groups was found for businesses with fewer than 10 employees and businesses with ten or more employees (Vignette 1: $p = 0.059$ and Vignette 2: $p = 0.048$). The smaller businesses agreed more strongly overall with both types of reward strategies. This may be because

smaller businesses may find more value in the reward providing a financial benefit or with respect to the positive exposure it might give them in their community.

Another significant difference with respect to Vignette 2 was found between respondents in the age group up to 30 and the age group 51 and older (p= 0.008; using a multiple comparisons table). This indicates that the younger respondents were much more positive about being rewarded with a certificate for their tax compliance than the older respondents. Kornhauser (2007) stated that older individuals are generally more tax compliant than younger ones. One of the reasons she suggested for this is that older individuals are more willing to follow or internalize social norms. This may, in part, explain the result of the difference in perceptions by age group in the present study: younger individuals appear to be more susceptible to being influenced, in other words, norms have not yet been strongly internalised.

All the other comparisons between different groups based on gender; type of industry; owner status; tax awareness and responsibility; whether or not respondents are using a tax practitioner; race; and level of education, yielded no statistically significant difference with respect to attitudes and beliefs about Vignettes 1 and 2. In respect of gender, this is contrary to the results of Bazart and Pickhard (2009) who found that the positive impact of rewards in the form of lottery winnings was particularly strong among male taxpayers.

4.5 Reliability

The consistency of responses was measured across each scale using the Cronbach alpha coefficient (α). A value of $\alpha = 0.774$ for the Vignette 1 scale, after two statements (B4 and B5) were re-coded by reversing the response categories as they were stated in the negative, and $\alpha = 0.943$ for the Vignette 2 scale resulted. Based on these values it can thus be concluded that the internal reliability of the two scales used in the questionnaire was acceptable.

5. CONCLUSION

It appears from the survey results that the small business owners included in the sample support acknowledgment by tax authorities of their tax compliant behaviour. Both scenarios were supported by the majority of the respondents, with the certificate-scenario receiving a slightly higher support. For both scenarios it was found that respondents believed that a reward system could have a positive effect on other small business owners' tax behaviour and reasons given for supporting the schemes were mainly that the schemes would have motivational value. It is noteworthy that a frequently cited concern with the possible implementation of such schemes was the fear of corruption.

It further appears that opinions did not differ between the industry, gender, race, or level of education, but that the variables of age and the size of business had an impact on opinions. Younger respondents were more in favour of the certificate scenario than those over 51 years of age, and respondents from smaller businesses agreed more strongly overall with both types of reward strategies than those respondents from businesses with 10 or more employees.

It is suggested that further research could be undertaken to determine the effectiveness of reward strategies in encouraging voluntary tax compliance in the countries where they are currently being used to determine the attitudes of those taxpayers in relation to the strategies; and to reveal the problems and disadvantages of using these strategies.

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TravelSmart or travel tax breaks: is the fringe benefits tax a barrier to active commuting in Australia? [1]

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Abstract

The Fringe Benefits Tax (FBT) provides tax incentives to employers and employees who use private motor cars to travel to and from work. However there is no broad exemption available to employers that support employees choosing alternative modes of commuting.

In this paper we explore schemes that some employers are currently implementing to promote active commuting, and how FBT applies to those schemes. We find that employers are frequently implementing arrangements without adequate awareness of potential FBT liabilities.

We argue that the current patchwork of exemptions is inadequate and that broad exemptions are required to support commuters who choose active travel alternatives.

Keywords: *Fringe Benefits Tax, active commuting, public transport, environment*

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1. INTRODUCTION

Smart commuting policies are policies that encourage Australians to use public transport, walking and cycling for commuting rather than a personal passenger motor vehicle to address the unsustainable increase in motor vehicle usage, particularly passenger motor vehicles. There have been many calls for all levels of Australian governments to promote smart commuting through policies that provide appropriate infrastructure and incentives, including tax incentives, to individuals and employers that promote such practices.

Without any policy changes that promote smart commuting, the low level of usage is likely to get worse. Not only will road-transport activity more than double by 2050 (Energy, 2012; para 3.3.8), but the Australian population is projected to grow and change over the next 40 years (Treasury, 2015). Passenger motor vehicles are currently the main form of transport to get to work or full time study. In 2012, 71 per cent of Australian commuters used passenger motor vehicles to travel to work or full time study, 16 per cent used public transport, four per cent walked and two per cent cycled (ABS, 2013).

The increasing number of motor vehicles on the roads imposes negative externalities such as congestion, greenhouse gas emissions, safety and health issues, reduced energy security and lower economic prosperity. By not promoting smart commuting policies, the Australian Government is also not fulfilling its commitment to the Global Community to preserve energy and protect the environment.

A range of policies are required at the federal and state government levels to encourage alternative forms of commuting. Public transport and cycling infrastructure need to be improved to meet the needs of commuters, and commuters need to be encouraged to change their behaviour.

It is time for the Australian Government to promote travel smart policies, which must also include fiscal legislation that impedes the adoption of alternative modes of travel (Pearce, 2011; 2014). The focus of this paper is to explore the constraints imposed by the Fringe Benefits Tax (FBT), how it hinders smart commuting and how a subsidy for smart commuting can be provided through policy changes to the FBT.

The paper is divided into five parts. Part 2 of the paper provides an overview of the operation of the FBT in Australia. In Part 3 we then present the findings from our survey of a focus group of TravelSmart co-ordinators who are responsible for encouraging smart commuting in their workplace. Part 4 explores how FBT applies to the range of benefits provided under these schemes, using case studies drawn from the focus group. Finally, we conclude that although there are ways to work within the current parameters of the FBT in developing schemes to support smart commuting, there is an urgent need for legislative reform, and we make some proposals for reform.

2. FRINGE BENEFITS TAX

It is well known that there are significant FBT concessions available to employees through salary packaging of cars, but there is also demand, currently small but increasing, for employers to support other forms of travel. The motives for providing alternative travel benefits vary, but both employers and employees cite congestion,

parking and health as reasons to adopt alternative forms of transport to and from work. However FBT is often cited as a barrier.

Australia is unusual, being one of only two countries in the world to impose FBT on employee benefits on employers, with the other being New Zealand. The purpose of the tax, which was introduced in 1986, is to ensure that tax is paid on non-cash benefits provided to employees where that benefit is for a private purpose by calculating the value of a benefit using an objective formula, and applying the maximum personal rate of tax to the pre-tax value of the benefit.

The structure of the FBT (FBTAA 1986) is schedular. A benefit is classified as falling within a particular category, and the relevant exemptions and calculations for each category are set out in separate divisions of the FBTAA. If there is a benefit that cannot be classified under a specific category, for example, the use of a bicycle owned by the employer, it is classified as a residual benefit under Division 12 to ensure that it does not escape FBT. The rules applied to calculate the taxable value for each category of benefit are intended to reach a value that is approximately equivalent to the arm's length value of the benefit, that is, the amount that unrelated parties would pay to acquire the goods or services in an open market. The value of the benefit is not taxed to the employee, although it will be included as adjusted taxable income used for the purpose of access to many other government payments, levies and charges.

There are exemptions, exclusions and reductions for a range of items where there is either a policy reason; for example, avoiding double taxation on superannuation contributions taxed in a superannuation fund (FBTAA s 136 Definition of Fringe Benefit, (j)); where it is a work-related obligation, such as health and safety obligations (FBTAA ss 58K, 58M); or where the employee is using the goods for work related purposes, such as the provision of professional subscriptions (FBTAA s 58Y). If the employee contributes to the cost of the benefit the taxable value is reduced (eg FBTAA ss 10, 39C), and there are exemptions for employees of charities and public hospitals (FBTAA ss 5A, 57A).

Although the valuation rules generally try to adopt a taxable value that is close to the arms length value of providing the benefit, there are some notable exceptions. Of particular relevance to this article there are concessional methods available to calculate the taxable value of benefits provided in connection with motor cars. Section 9 of the FBTAA allows the use of a statutory formula to calculate the taxable value of a car based on the value of the vehicle without reference to the true cost of operating the vehicle. The employer and the employee receive an indirect tax benefit as the statutory formula does not differentiate between private and business travel.

The concessional method of calculation of the liability on motor cars was designed to protect the domestic motor vehicle industry when the tax was introduced. It has existed since the tax was introduced, although it was scaled back in 2011 to reduce the concessional rate to 20 per cent regardless of the distance travelled. Further reforms to remove the concessional calculation proposed in 2013 were opposed by the motor vehicle and finance industries, and did not ultimately proceed.

Parking also receives concessional treatment under Division 10A which allows a number of methods of calculating the taxable value of parking benefits that do not necessarily correlate to the cost of providing that parking. These alternative methods were introduced in order to simplify the calculation of FBT on parking.

Since the introduction of the FBT in 1986 the practice of salary packaging, or salary sacrificing, has become pervasive. Salary packages incorporate tax preferred benefits to minimise tax obligations, notably superannuation contributions that exceed the mandated superannuation guarantee rate and provision of a motor car that can be used for private purposes. The employee negotiates a lower cash salary with the inclusion of salary packaged items. Generally any FBT liability is passed from the employer to the employee in the arrangement.

However other forms of transport do not fall within tax preferred categories. This creates a tax subsidy for private motor vehicles as a form of transport.

3. THE FOCUS GROUP

3.1 TravelSmart

TravelSmart Workplace is a component of the WA Healthy Workers Initiative which is jointly funded by the Western Australian and Australian Governments. It is designed to promote active travel, facilitating a range of workplace initiatives to reduce the use of cars and increase the use of alternatives including public transport and cycling (WA Department of Transport, 2015a).

The benefits of the TravelSmart programme are based on efficiency gains through improved access and reduced parking costs, health and productivity benefits for employees, and reduction of the environmental footprint of the business.

TravelSmart programme co-ordinators in each participating workplace, drawn from both the government and the private sector, are invited to become part of a network co-ordinated by the Department of Transport. They receive a regular newsletter and are invited to participate in quarterly seminars to discuss issues relevant to the programme.

The authors were approached by the Travelsmart co-ordinator to run a seminar on the application of FBT to a range of travel incentives. This seminar, which was held in November 2014, formed an opportunity to hold a focus group to discuss the various incentives that the TravelSmart workplaces are offering employees and any barriers created by the tax system. As this focus group was a self-selected group of Travelsmart co-ordinators who were already committed to smart commuting policies the findings cannot be attributed to the general population. However, it does form a useful case study of the practices being implemented by committed employers, and the impediments to implementation of such practices.

Preliminary discussions indicated that the benefits most likely to be offered would be classified as expense payments, provision of property or residual fringe benefits that do not fall within a specified category. The seminar commenced with an overview of the FBT as it applies to car fringe benefits, parking fringe benefits and the other identified fringe benefit types. Participants were then invited to discuss the programmes available in their workplace, any incentives they have considered introducing and any barriers to the implementation of those programmes. Before leaving, participants were asked to complete a survey (Appendix 1). Subsequently the authors undertook indepth interviews with selected participants to obtain more detailed information about their incentives.

3.2 Data analysis

Twenty-two surveys were returned, therefore an Excel spreadsheet was considered to be the most appropriate tool for analysis. Of the 22 surveys returned, 12 were from government departments, five from not-for profit organisations and only three were from private sector employers. Most attendees described their role as one of: occupational health and safety, policy or sustainability officers (Question 3). This indicates that the TravelSmart programme is regarded as either a health or an environmental initiative in most participating organisations. There were three managers and two facilities managers, responsible for parking allocations, but there were no finance officers in attendance. One participant reported that they were developing a third party provider model for active travel.

Question 2 asked for information about the physical premise of the employing organisations. There were nearly twice as many suburban premises (15) as CBD premises (8), although some organisations had more than one office. Most premises had parking facilities: over half (13) had parking provided by the employer, although in one case this was only available to senior management, and another five had commercial parking within 1 km. Thirteen, or 56 per cent, of the premises were reported as being close to public transport.

Question 4 explored the reasons why employers were implementing TravelSmart incentives. Environmental concerns (14) were second to parking issues (16); followed by employee concerns (10) and productivity gains (8). Two surveys specified employee retention as a reason for implementing the programme, and two were motivated to set an example.

Question 5 asked which of a range of programmes were available in a particular workplace, then allowed the participants to nominate which they would like to make available. Each of the listed incentives had strong support, as shown in the following table.

Table 1: Various TravelSmart programmes available or desired by surveyed participants

OPTIONS	AVAILABLE	DESIRED	TOTAL
Travel allowance for alternative methods of transport	10%	59%	69%
Provision or subsidy of travel passes/SmartRiders	23%	55%	78%
SmartRiders for work related travel only	23%		
Reward schemes for staff not driving to work	14%	55%	69%
Challenge schemes/competitions with rewards	18%	45%	63%
Provision of bicycle—prize or hire arrangement	32%	45%	77%
Discount to bike shop	5%		
Workplace facilities for active travellers,, eg change rooms, bicycle storage facilities	95%	5%	100%
Active commuter time allowance in working day	nil	55%	55%

Almost all employers had end of trip facilities, although in some cases they needed to be upgraded or were inadequate for current demand. The only employer not providing facilities is planning to relocate office. The next most popular incentive, both available and desired, was subsidised SmartRiders, which is the electronic tag used on public transport in Perth. Half of the SmartRider subsidies were only provided to employees for work related travel (such as meetings in work time) and another 10 per cent offered travel allowances of $6 or $9 per day. This was also the most desired incentive. The suggestion of an active commuter time allowance to allow an employee to take public transport during the working day or to recognise the time required to change clothing was the least popular at 55 per cent and has not been implemented anywhere.

Respondents were given the opportunity to expand on these responses. The comments included the following further information in relation to specific schemes:

1. the number of cars kept available in a car pool for work related travel was reduced by providing taxi vouchers or corporate SmartRiders;

2. electric bikes were acquired through a grant and are available through a bike pool system;

3. provision of a 20 per cent subsidy on SmartRiders used to travel to and from work (refer to Case Study 3 in Part 4 below);

4. a union intends to include active travel incentives in the next bargaining round of the relevant industrial award;

5. two week's public transport fares provided to employees; and

6. the Frequent Alternative Traveller reward scheme (refer to Case Study 4 in Part 4 below).

The final section of the survey asked respondents to identify the take-up rate of SmartTravel incentives, barriers to implementation and how those barriers could be removed. About half of the surveys reported barriers related to tax or red tape—internal as well as governmental. Parking was the other significant barrier: as long as parking is provided by employers for employees, there is little incentive to employees to change their behaviour. The third most commonly cited barrier was cycling infrastructure and safety issues. Awareness of the incentives available within an organisation, overcoming inertia and needing a champion also came up regularly. There were several comments that management did not give real support to these programmes, particularly in the public sector that, at least in WA, is driven by economic imperatives and is not seen to be taking climate change seriously.

4. FBT IMPLICATIONS OF TRAVELSMART INITIATIVES

4.1 Car benefits

The benefits of salary packaging cars are well understood and heavily promoted. Cars are currently the second most popularly packaged benefit, behind superannuation contributions. With the enhancement of novated lease agreements, the combination of pre- and post-tax contributions by the employee, and inclusion of FBT costs in the packaged cost, generally car benefits can be packaged with no FBT liability to the employer. Accordingly the decision as to whether an employee will enter into a salary sacrifice arrangement in respect of a car is based on the financial benefit to the employee.

The environmental consequences of the concessional calculation of the car benefit have been detailed elsewhere (Henry, 2010; Mortimore, 2011; Lignier, 2011). Since the Henry Review was published in 2010, there have been two attempts to reform the car concession, justified at least partly on environmental grounds. With effect from 10 May 2011 the statutory formula available under s 9 FBTAA was modified to a flat rate of 20 per cent of the value of the car regardless of the distance travelled during the year. Under the stepped rates in place until that date that reduced the tax payable as the distance travelled increased, taxpayers on the cusp of the next, lower distance band would increase their use of the car to cross the threshold. Not only did this reduce the revenue collected, on environmental grounds it encouraged excessive use of the car.

In 2013 the Labor Government announced plans to remove the statutory formula method of calculation. This would significantly decrease the concession for employees who were not using the car for work related purposes as they would be required to keep a log book, and the tax would be calculated on the value of the private use of the car: similar to most other fringe benefits. It was estimated at the time that the measure would affect about 320,000 employees who had salary sacrificed motor vehicles but did not use them for work purposes (Bowen, 2013). This proposal was fiercely opposed by the (then) Coalition Opposition and by business interests. Interestingly, in addition to the motor vehicle manufacturing sector the industry sector that was most prominent in opposing the reform was the finance and

leasing sector, which indicates how the practice of salary sacrificing to acquire a motor car has become embedded in remuneration packages.

On environmental grounds, to the extent that decisions over transport are price sensitive, any increase in the FBT paid on a car package would contribute to a reduction in the use of the car. Notably this reform was proposed in conjunction with the introduction of changes to the transition from the Carbon Tax to a floating carbon price.

Unsurprisingly, the proposal was abandoned in November 2013 after the Coalition was elected.

Given that the FBT concession that subsidises the use of private cars for travel to and from work is not likely to be removed, a similar concession should be made available for active travel. This would address the tax bias that encourages the use of motor cars to travel to work and would promote alternative, more environmentally friendly, forms of commuting.

4.2 Parking

Provision of parking to employees is a fringe benefit. It is independent of car benefits, but it is likely that a business that allows employees to salary sacrifice a car would also have to account for parking benefits.

A car parking benefit is defined in s 39A FBTAA. It arises where an employer provides parking on its premises for employees during a working day, if there is a commercial parking station within 1 km of the premises that charges more than the parking threshold, which was $8.26 per day for the year ended 31 March 2015.

There are a number of ways that the taxable value to the employer of a car parking benefit can be reduced below the arm's length rate, or completely eliminated:

1. there is no car parking benefit if there is no commercial parking station within 1 km of the business premises that charges more than the parking threshold (ss 39A(1), 9B);

2. the employee must park there for more than four hours on a relevant day (s 39A(1)). Accordingly there is no liability in respect of workers who travel during the working day or part-time employees who work for less than four hours a day;

3. employers with a turnover less than $10m are exempt from FBT on parking as long as the parking is not at a commercial station (s 58GA);

4. there is a choice of simplified calculation methods, which tend to give a value lower than the actual cost of providing the parking (Div 10A); and

5. a parking benefit that is not within the definition in s 39A may be either a residual fringe benefit if the parking is provided, or an expense payment benefit if the employee is reimbursed. However both of these are exempt from FBT (s 58G(1)).

Clearly there are some business needs that are met by the exemptions, particularly where a business has employees that are on the road for part of the working day, or

where the premises are not readily accessible by other means of transport, employees can reasonably expect to be able to park at the business premises while attending the office.

Given that parking and congestion is listed as one of the main reasons for business to promote active travel, the concessional nature of FBT on parking does not align with this agenda. However, planning regulations are an additional tool that can be used in some circumstances to reduce parking demand.

Case study 1: University parking

The WA Planning Commission has determined that no additional parking areas will be allowed in 'priority zones', which affects large public institutions including universities. Parking on campus has traditionally been relatively cheap, with a non-reserved bay costing $500 pa or $3 per day in the 2014 calendar year; and with permits not required outside teaching periods.

Currently there is no FBT payable in relation to staff permits as there is no other commercial parking station within 1 km of campus.

The university has adopted a policy of increasing the cost of parking over three years to the equivalent of a two-zone fare (about 20 km) on public transport which is currently $4.40. For the 2015 calendar year the cost of permits was increased to $700 pa, and permits will be phased out over a three year period. It is hoped that this will encourage employees (and students) to choose public transport over campus parking where that is a viable alternative.

However the availability of salary sacrifice arrangements for parking permits is a limitation on the parity pricing arrangements. The pricing structure is such that staff attending campus for three or fewer full days in a week should find it cheaper to pay the daily rate than purchase a permit. Once salary sacrificing arrangements are factored in in relation to permits, there is no price signal to switch from permits to daily parking rates.

The local government council is currently planning to establish a commercial parking station in an adjacent business area, which would bring the university parking within the s 39A definition of a car parking benefit. However the benefit would still be exempt under subs 58G(2)(d) which exempts a car parking benefit provided by a public educational institution.

Clearly the availability of parking for commuters needs to be considered by both the employer and the local planning authorities. In some situations imposing planning restrictions or charging long term parking fees, will result in an FBT price signal that could drive a change in commuter behaviour.

4.3 Travel allowances/subsidies

Where congestion is caused by competition between the clients of a business and employees of that business, the employer may need to seek more creative solutions to parking congestion issues. The solutions raised by our focus group included travel allowances or travel subsidies.

Where a 'green travel' allowance is paid to employees, it is not subject to FBT but is instead taxed in the hands of the employee (s 6-5 ITAA97). To the extent that the travel allowance relates to travel to and from work there would be no offsetting income tax deduction available, accordingly the amount of the allowance would need to be sufficient to allow for the tax effect.

Case study 2: Travel reimbursement

A Sydney based business relocated from a number of locations across the city to a single office. The property was a 'green building' within 500 m of a train station, with limited parking attached to the building. The employer offered a relocation incentive to employees moving from other locations. Parking was allotted to employees who car-pooled, and employees who took public transport were eligible for a Travelpass, which at the time was a prepaid paper based ticket.

In the first year the employer purchased the Travelpass quarterly to employee specifications, thus incurring a FBT liability.

In the second year the employer changed to an allowance, paid with monthly pay. Following employee representations, the rate of the allowance was adjusted to reflect the tax effect: for example, in 2013 a quarterly two zone Travelpass cost $550 ($2,200 pa), with the allowance increased to $326 per month ($3,912 pa) for an employee paying 40 per cent income tax (+levies).

If an employer pays a travel provider directly or reimburses verified purchases, a travel subsidy is an expense payment fringe benefit as the employer reimburses a proportion of the cost of the employee travel (FBTAA s 20). Unless the employer is a public transport authority, in which case special rules apply (FBTAA s 47) and the taxable value of the benefit would be the amount that the employer pays to the employee or the third party in respect of the travel. Subsidised public transport is particularly useful where the employer is located in close proximity to public transport: for example, in the CBD or at large public facilities including hospitals or universities where employees and clients compete for parking space.

The survey indicates that 78 per cent of the respondents would prefer the provision of a subsidy or travel passes. However, employers can be reluctant to provide such a subsidy as it has FBT implications. An FBT subsidy in this area would enhance the use of public transport, bringing about substantial savings in negative transport externalities such as congestion, emissions and other health and environmental impacts.

Most Australian capital cities are now moving to electronic payment of fares, and phasing out prepaid travel, with discounts for frequent users or adding value through bank account debits when credit reaches a specified level. This raises practical and administrative issues that the employer needs to consider.

Case study 3: Public hospital—parking congestion

A public hospital has instituted a system of subsidised travel to and from work through the use of subsidised travel passes. The reason for making this subsidy available is to address issues of parking congestion on the hospital precinct.

The employee enters into an agreement with the employer to be issued with a travel card that can only be used for travel to and from work. The hospital co-ordinator arranges for the employee contribution to be deducted from their bank account fortnightly. Under a Memorandum of Understanding with the transit authority a further 20 per cent discount is applied to fares paid on this card in addition to the other discounts available giving a total 45 per cent discount on the cash fare.

Travel on the card is restricted to travel between home and work and the employee must relinquish any weekday parking permit, although shift workers can park on site on the weekends if public transport options are limited. To monitor compliance a number of steps are taken:

- all employees that apply to participate in the program are required to meet with the co-ordinator where the conditions of use are explained;
- the participant signs an agreement to comply with the conditions of use;
- the card is badged as an employer issued card; and
- usage is audited regularly: 10 per cent of cards are audited every three months.

When introduced the programme was overwhelmed by applications from staff, and currently there are more than 1,000 participants, which represents about one third of the workforce.

In this case study, the motivation was to address parking issues, and FBT was not a consideration in the design of the scheme. Therefore the employer pays the tax.

However, many of the employees working at the hospital would be eligible for FBT exempt benefits as benefits provided to employees of public hospitals in respect of their employment are exempt benefits up to an annual cap of $17,000 (FBTAA ss 57A, 5B). If implemented, salary packaging would reduce the cost of transport to eligible employees even further, depending on the marginal tax rate of the employee.

In this case, the administrative cost of managing the scheme is the main barrier to extending the scheme to other hospitals.

Other employers that are located in the CBD or are otherwise serviced by good public transport networks are making corporate public transport cards available for work related travel during the working day. This removes the incentive to bring a car to work if the employee has to attend a meeting off the premises during the day. There are, however, limitations to the practicality of using public transport, therefore the public transport cards may need to be supplemented by taxi fares where public transport is not a feasible alternative. There are no tax consequences in relation to travel paid by the employer for work related purposes, as these would either be an exempt benefit or the value would be cancelled by the application of the ‘otherwise

deductible rule' which provides that the taxable value of a benefit is reduced by the amount that the recipient would be entitled to claim as a tax deduction if they paid the amount themselves (FBTAA ss 24, 44, 52).

However proposals that rely on public transport depend on public transport being in proximity to both the home and the workplace of the commuter.

Some employers provide bicycles or power assisted bicycles for employee use for short distance travel, which constitutes a residual fringe benefit. Where that use relates directly to their duties in the workplace there are no FBT consequences as the benefit is exempt (FBTAA s 47(3)). However if the employee is allowed to use the bicycle to travel between home and work, a fringe benefit arises in relation to that travel.

4.4 Provision of workplace facilities

One of the barriers to employees choosing to use alternative transport to commute to work is access to appropriate facilities to freshen up before the start of their work day. Although many older commercial buildings do not have appropriate facilities, in the focus group sample all except one employer provided shower and change facilities, and that employer is planning to move to new premises that will have such facilities.

Many local government planning schemes require developers to make provision for 'end of trip' facilities in new commercial developments and a number of significant inner city residential developments are providing bicycle facilities in addition to parking. The Sydney City Access Strategy states that: 'We will also look at opportunities for public bicycle parking and encouraging end of trip facilities such as showers and lockers' (Transport NSW, 2013). In addition to the provision of public bicycle parking areas, bicycle parking spaces are exempt from the Parking Space Levy (Parking Space Levy Regulation 7(1)(a)), currently $2,260 pa, which generally applies to any non-residential off-street space used for parking within the Sydney CBD and North Sydney and at the lower rate $800 for other leviable areas in NSW.

Other end of trip facilities, specifically showers and lockers, are becoming increasingly important in new commercial developments, with new buildings incorporating high end changeroom facilities in order to attract tenants (Han, 2015).

Some local councils have incorporated minimum requirements for bicycle facilities in their town planning schemes. For example, the Victoria Planning Provisions provide a template for minimum requirements for bicycle facilities for a range of building uses, specifying requirements for bicycle parking, showers and changerooms. Under the plan new office developments are required to provide the following facilities (Transport Victoria, 2006, Clause 52.34):

1. long term bicycle parking: one space for each 300 m^2 of office space, if net floor area exceeds 1,000 m^2;

2. visitor bicycle parking: one space for each 1,000 m^2 of floor space, if net floor area exceeds 1,000 m^2;

3. showers: if five or more employee parking spaces are required, one shower + one for every 10 additional spaces; and

4. changeroom: access to a changeroom from each shower or the shower may be a combined shower/changing cubicle.

The provision of end of trip facilities to employees that use alternative modes of transport does not result in any FBT consequences as those facilities are exempt from FBT. Exemptions are available in respect of property consumed on the premises on a working day, on business premises (FBTAA s 41); and for residual benefits resulting from the use of employee amenities (FBTAA s 47(3) as defined in s 47(4)), on the employer's business premises.

There are also a number of special events promoted by external organisations, such as Ride2Work Day, to encourage changes in commuter behaviour. Employers are encouraged to support participants in these events through the provision of breakfast or other refreshments. Employers could go further and even establish a regular event for employees. The Australian Taxation Office has determined that morning and afternoon teas and light lunches provided to employees on the employer's premises would not constitute meal entertainment, and an income tax deduction is allowable (TR97/17). Arguably, where a light meal is provided at the start of the business day, it could be considered a light meal as discussed in paragraphs 113–114 of the ruling as the purpose of the provision is refreshment not recreational. Accordingly there would be no FBT payable.

It is important to note the distinction between a light meal and a social event. Where an event is considered to be a social function and the employer is a taxable employer the exemption under s 41 is not available and no tax deduction is allowable (TR 97/17, para 25). If the value is less than $100 and is provided irregularly and infrequently it would then fall under the exemption for minor benefits under s 59P.

4.5 Alternative commuter benefit plans

Another approach to encourage alternative commuting is to construct a scheme that provides incentives for employees choosing to use alternative methods of transport. FBT is an important consideration in constructing such a scheme. If the reward is based on the payment of an expense or provision of property to an employee, or is a residual fringe benefit such as the use of a bicycle owned by the employer, a fringe benefit may arise.

In constructing such a scheme, the exemptions that are available within the FBTAA can be used to reduce any FBT liability. The most significant of these is the minor benefits exemption, under s 58P FBTAA, which exempts a benefit with a value of less than $300. However there are constraints around qualification for the minor benefits exemption.

Firstly, the benefits must be infrequent, which takes its ordinary meaning; and secondly, if associated benefits are granted during the year, they need to be aggregated when determining the value of the minor benefit. Thirdly, an in-house benefit cannot be a minor benefit, and finally it must 'be concluded that it would be unreasonable to treat the minor benefit as a fringe benefit in relation to the employer in relation to the current year of tax' (FBTAA s 58P(f)). These requirements present a challenge in designing an incentive scheme that is intended to change the behaviour of employees.

An incentive scheme could be based on the employee accruing points for continuing use of alternative modes of transport; or structured with benefits provided on an ad

hoc basis. If the scheme allows the employee to accrue points towards a reward, any tax is payable at the time at which the reward is received (PSLA 2004/4 (GA)).

However, if points are accrued on an ongoing basis it could disqualify the benefit from being a minor benefit if the level of points required to redeem a reward is established at a level where employees could be expected to receive rewards regularly during the FBT year. The Australian Taxation Office has considered a number of reward style schemes in relation to employment (TR 2007/12), and has determined that a scheme based on sales targets was not exempt from FBT as a minor benefit as it was expected that staff would qualify for rewards (TR 2007/12, example 8), but an ad hoc bonus to an employee that is not part of a formal scheme would be considered to be a minor benefit (TR 2007/12, example 9).

Case study 4: Frequent Alternative Traveller (FAT) Rewards Scheme

A Perth based environmental consultancy business with fewer than 20 employees has established a points based scheme for active travellers. The motivation was primarily environmental. Given the nature of the business the employees are conscious of the impact of commuting on the environment, and the firm wants to display its environmental credentials.

The FAT Rewards scheme allows employees to accumulate points for alternative methods of commuting. The scheme allows an employee to accumulate points depending on the mode of travel:

Active transport: three points each way

Public transport: two points each way

Motorcycle/carpool/powered bicycle: one point each way

Each point is valued at 50c. Accumulated points can be used as follows:

- to purchase prepaid or add credit to Smartriders;
- to purchase health related equipment or services;
- a contribution to a nominated charity, which is matched by the employer; or
- to repay a loan (up to $1,000) to purchase a bicycle

Over 75 per cent of staff participates in the scheme, with several employees completely changing their usual mode of travel. One employee who lives in an outer suburban centre now exclusively uses public transport and has redeemed her points by purchasing prepaid Smartriders. The current Smartrider fare is $6.55 each way, which is effectively reduced by $1 each way: a 15 per cent discount.

This scheme was designed without any consideration of the FBT impact or any available exemptions.

The benefits that could arise include a fringe benefit on the notional interest payable on the advance to purchase a bicycle which would be valued at the prevailing benchmark interest rate, currently 5.95 per cent; and expense payment benefits in relation to the reimbursement of the authorised expenses. An expense payment benefit can be exempt if the employee lodges a declaration that there was no private

use of the goods or services that have been reimbursed, but this exemption is not available in relation to the types of items listed in the scheme.

An individual employee could accumulate up to $720 value of points over a year. Although it is unlikely that any single redemption of points would reach the $300 threshold for a 'minor benefit', it is likely that multiple payments of the same type, for example, multiple payments to a Smartrider, will be considered to be associated benefits and would therefore be accumulated and tested against the $300 threshold. There is also the possibility that all reimbursements to an employee under the FAT Scheme would be accumulated as they are accumulated under a single scheme with specified terms and conditions.

This scheme won the 2014 Travelsmart Innovate Award (WA Department of Transport, 2015b).

4.6 In-house benefits

An in-house benefit is a benefit provided by an employer where the employer would normally supply identical or similar property or benefits to outsiders; for example where a bicycle retailer provides a bicycle to employees (FBTAA s 136). It can be a property benefit, an expense payment benefit or a residual benefit. Such a benefit may be made available to employees as part of an employee remuneration agreement, or in conjunction with a rewards scheme.

In respect of in-house benefits, the aggregate notional taxable value of benefits that can be provided without the imposition of FBT increases to $1,000 pa (FBTAA s 62). Note, however, that with effect from 22 October 2012 this exemption does not apply to in-house benefits provided under a salary sacrificing arrangement (FBTAA s 62(2), TR 2007/12, paras 123–129).

Case study 5: In-house benefit: public transport

Employees in the Queensland Public Service are entitled to enter into salary packaging arrangements. Prior to 2013, this included access to public transport on government operated services up to a value of $1,333 per annum, based on the s 62 in-house reduction in value (Housing and Works Qld, 2013). However following the amendments to the legislation that removed the exemption in respect of salary packaged benefits, the benefit is now a fully taxed benefit when included in a salary packaging arrangement (Housing and Works Qld, 2014).

Public transport fares remain exempt from FBT in two circumstances: where an employee of a transport company or a police officer is provided with free transport to and from work (FBTAA s 47(6)). Note that this does not extend to non-work related travel, which excludes commuting between home and work (ATO ID 2009/140).

Two of the fundamental concepts of the FBT are that the benefit must be provided by an employer to an employee and be in respect of employment. However, in order to protect the integrity of the tax, the tax cannot be circumvented by using a third party provider. Under the FBTAA a fringe benefit includes a benefit provided by another party under an arrangement with the employer, or where the employer facilitates or promotes a scheme promoted by another party (FBTAA s 136). However it can limit the ability to promote Travelsmart schemes through the employer where there is a reward attached.

Case study 6: Third party rewards scheme

A software developer is working on a mobile application to track the mode of travel adopted by commuters. The app will be able to determine the mode of travel; that is, walking, cycling or public transport; and the distance travelled. Points will be awarded to the commuter based on the mode and distance of travel. The points will be able to be redeemed for rewards.

The program will be administered by the software developer, not by the employer. However the software developer will be involving a number of employers to promote the app among their employees and to provide rewards that can be redeemed by any participating commuter.

On the face of it, there is no FBT liability as the software developer does not employ the participants in the rewards scheme. However if the software developer enlists the support of the employer, any benefits would be fringe benefits and would impose a liability on the employer, not the software developer.

5. REFORMS TO PROMOTE SMART COMMUTING

It is time for the Australian Government to make changes to promote smart commuting, especially policies that encourage the use of public transport (Pearce, 2014; Pearce & Pinto, 2015). In this respect, the Australian Government should review its fiscal policies in order to promote smart commuting. The most important policy change would be to make changes to the FBT regime to allow exemptions for smart commuting that are on a par with incentives provided to car travel.

In order to promote smart commuting, the Australian Government could carry out reforms such as providing an exemption from FBT if the employer pays or subsidises an employee's public transport fares to travel to and from work.

Governments in many countries heavily subsidise public transport services, for example the US government subsidises up to 89 per cent of operating cost of some rail and bus services (Parry & Small, 2009). This subsidy to encourage the use of public transport can be provided directly, or through tax policy design such as the FBT.

There should be a specific exemption incorporated in the FBT legislation to allow employers to subsidise travel between work and home for an employee. There are two options to design the exemption: it could be restricted to travel between work and home, or it could be extended to all travel on a specific travel card. On balance, the cost involved in managing a system that limits the benefit to travel between home and work, and the relatively low cost of public transport compared to provision of a car, does not justify the more limited exemption. It would, however be appropriate to limit the concession to a single traveller, or electronic card, each year.

Cycling alternatives could also be eligible for tax concessions. The Australian Government should follow the example of other countries in the world that are promoting alternative travelling initiatives to promote health, such as the Cycle to Work Alliance in the UK that was introduced in the *Finance Act 1999* (UK) and provides a tax efficient work initiative encouraging employers to loan bicycles and

cycling equipment to travel to work (Cycle to Work Alliance, 2011). The cycle to work scheme is the second most popular salary sacrifice employee benefit in the UK. A behavioural impact analysis carried out on the Cycle to Work Alliance in the UK in February 2011 revealed that 87 per cent of the respondents noticed a health benefit from cycling to work and 84 per cent of users believed the scheme was an important and easy way to keep fit. Ireland has also introduced an exemption from income tax when an employer provides a benefit-in-kind arising from a bicycle or bicycle safety equipment to its employee to use it for qualifying work related journeys (Irish Tax and Customs).

Unlike the European policies, cycling plays only a minor role in Australia in reducing car use. The focus group exercise set out in this paper indicates that safety was a significant factor in the decision of how to travel to work. The Australian Government should not only provide tax breaks to encourage cycling to and from work, but also implement policies that make cycling safe and convenient with properly lit cycle paths and bicycle storing facilities near public transport hubs. Due to lack of Australian Government policies encouraging bicycle use to travel to and from work, the bicycle usage rate is very low when compared with international standards, despite the fact that bike ownership in Australia is among the highest in the world (Australian Conservation Foundation, p. 8).

6. CONCLUSION

Currently an employer that chooses to encourage alternative commuting strategies, whether cycling or the use of public transport has to negotiate the complexities of the FBT if they wish to limit any exposure to the tax (Hodgson, 2015). Our discussions with employers that have facilitated the change have, in general, developed schemes despite FBT, either accepting any liability or designing a scheme to fit available exemptions.

However an employer who is committed to environmental principles may not be aware of the potential FBT liability, exposing their business to the risk that they are not complying with the legislation. This is in stark contrast to the FBT subsidies available for the provision of motor cars and parking; and the well established support systems in place for these benefits.

It is time that the FBT was reformed to reduce the concessions given to motor cars and to facilitate the provision of alternative methods of travel. As noted in the Henry Review:

> Tax concessions introduced for non-environmental purposes but which promote behaviour with adverse environmental consequences should be reviewed. Such a review would consider whether the social benefit of the activity supported by the concession outweighs the social cost associated with the environmental damage. (Henry, 2010, p. 371).

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8. APPENDIX

(University Letterhead)

PARTICIPANT SURVEY

By completing this form, you are consenting to participate in the questionnaire that will be used for the purpose outlined in the attached Information Sheet.

TRAVELSMART FORUM
26 November 2014
140 William St, Perth

1. In which sector is the organisation you represent active:
    a. Government
    b. Private
    c. Not for profit
    d. Other _____

2. The operational premises are located :
   (mark all those that apply)
    a. CBD
    b. Suburbs
    c. Outer metropolitan
    d. Close to a transport hub
    e. Within 1 km of parking
        i. Employer provided on the premises
        ii. Commercial parking stations

3. What is your role in the organisation
    a. Human resources
    b. Finance
    c. Management
    d. Other _____

4. What is the motivation for your organisation to offer travelsmart incentives to employees?
    a. Productivity gains
    b. Parking and traffic congestion at the workplace
    c. Environmental concerns
    d. Responding to employee concerns
    e. Possibility of a congestion tax
    f. Other _____

5. Which of the following categories of initiatives are available, or would you like to be available in your organisation?

Available	Program	Desired
	Travel allowances for alternative methods of transport	
	Provision or subsidy of travel passes/smart riders	
	Reward schemes for staff not driving to work	
	Challenge schemes/competitions with rewards	
	Provision of bicycle – prize or hire arrangement	
	Workplace facilities for active travellers eg change rooms, bicycle storage facilities	
	Active Commuter Time allowance in working day	
	Other:	

6. Please give further details of how these incentive schemes work (or could work) in your organisation

7. What is the take-up rate for the incentive(s) offered by your organisation?
    a. _____
    b. _____
    c. _____

8. What are the barriers to employees taking up these incentives?
    a. _____
    b. _____
    c. _____

9. What are the barriers to the organisation offering the additional incentives identified above?
    a. _____
    b. _____
    c. _____

10. What government incentives would help to remove these barriers?
    a. _____
    b. _____
    c. _____

11. Would you like to add any further comments?